SUBCHAPTER S REVISION ACT OF 1982

HEARING

BEFORE THE

SUBCOMMITTEE ON
SELECT REVENUE MEASURES

OF THE

COMMITTEE ON WAYS AND MEANS
HOUSE OF REPRESENTATIVES

NINETY-SEVENTH CONGRESS

SECOND SESSION

ON

H.R. 6055

TO REVISE SUBCHAPTER S OF THE INTERNAL REVENUE CODE
OF 1954 (RELATING TO SMALL BUSINESS CORPORATIONS)

JUNE 14, 1982

Serial 97-64

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SUBCHAPTER S REVISION ACT OF 1982

MONDAY, JUNE 14, 1982

House of Representatives,
Committee on Ways and Means,
Subcommittee on Select Revenue Measures,
Washington, D.C.

The subcommittee met at 9:15 a.m., pursuant to notice, in room 1100, Longworth House Office Building, Hon. Fortney H. (Pete) Stark (chairman of the subcommittee) presiding.

Chairman Stark. The subcommittee will come to order.

This morning we are going to receive testimony on the Subchapter S Revision Act of 1982, introduced by Chairman Rostenkowski and Mr. Conable. The bill is intended to simplify the tax rules relating to the eligibility for subchapter S status and the operation of subchapter S corporations.

While based largely on the recommendations of the staff of the Joint Committee on Taxation in their April 30, 1980, report, the introduced bill is the product of efforts by the staffs of the Committee on Ways and Means, the Senate Finance Committee, and the Department of the Treasury, with valuable assistance from outside professional groups.

I might add some of the members of the American Bar Association, the CPA Institute and the California State Bar, and former members of the Joint Committee staff, who will testify today, were of invaluable help drafting this legislation, and the staff and members are very appreciative.

There are a number of issues, however, which are not addressed in the bill as introduced because of differences of opinion within the tax community concerning the appropriate tax treatment of these items.

We are particularly interested in testimony of the following issues: first, the proper treatment of regular corporations electing subchapter S; second, whether the present law limitation of one class of stock is appropriate; and finally, whether limits on foreign income are appropriate.

At this point I would ask, without objection, that the press release announcing this hearing be made a part of the record.

[The press release and bill follow:]

[Press release of Thursday, May 13, 1982]

HON. FORTNEY H. (Pete) STARK, CHAIRMAN, SUBCOMMITTEE ON SELECT REVENUE MEASURES, COMMITTEE ON WAYS AND MEANS, ANNOUNCES A PUBLIC HEARING ON H.R. 6055, "THE SUBCHAPTER S. REVISION ACT OF 1982" TO BE HELD ON MONDAY, JUNE 14, 1982

The Honorable Fortney H. (Pete) Stark, Chairman, Subcommittee on Select Revenue Measures, Committee on Ways and Means, U.S. House of Representatives, today announced a public hearing on H.R. 6055, the "Subchapter S Revision Act of 1982," to be held on Monday, June 14, 1982. The hearing will be held at 10:00 a.m. in the Committee's main hearing room, 1100 Longworth House Office Building. The lead-off witness is expected to be the Honorable John E. Chapoton, Assistant Secretary of the Treasury for Tax Policy.

In announcing this hearing, Chairman Stark stated that "It is appropriate that the Subcommittee consider this important simplification legislation at this time and that members of the public be afforded an adequate opportunity to comment on these significant revisions to subchapter S of the Internal Revenue Code."

BACKGROUND

The "Subchapter S Revision Act of 1982," introduced on April 1, 1982, by Chairman Rostenkowski and Mr. Conable, is intended to simplify the tax rules relating to eligibility for subchapter S status and the operation of subchapter S corporations (sometimes referred to as electing small business corporations). The bill is largely based on recommendations made by the staff of the Joint Committee on Taxation, published on April 30, 1980. However, the introduced bill is the product of efforts by the staffs of the Committee on Ways and Means, Senate Finance Committee and the Department of the Treasury, with valuable assistance from outside professional organizations.

H.R. 6055 attempts to achieve simplification by removing eligibility restrictions that appear unnecessary and by revising the rules relating to income and distributions that tend to create traps for the unwary. The changes in eligibility restrictions which the bill would make include: (1) increasing the number of permitted shareholders from 25 to 35; (2) permitting differences in voting rights in common stock; and (3) eliminating the requirement that no more than 20 percent of the corporation's gross receipts may be passive investment income if the corporation does not have accumulated earnings and profits at the end of a taxable year.

The bill would also make some changes in the tax treatment of certain activities of subchapter S corporations. It would require that individual items of income and loss pass through to the shareholders in the same general manner as partnerships. Foreign taxes would be passed through to shareholders. Depletion provisions, as well as fringe benefit and pension rules, would parallel partnership treatment. Distributions out of subchapter S earnings would be tax-free up to the shareholder's stock basis, rather than taxed as dividends.

Several important issues are not addressed in the introduced bill because of differences of opinion within the tax community concerning the appropriate tax treatment of these items. The Subcommittee specifically invites comment on these issues: first, the proper treatment of regular corporations electing subchapter S; second, whether the present law limitation of one class of stock is appropriate; and finally, whether limits on foreign income are appropriate.

DETAILS FOR SUBMISSION OF REQUESTS TO BE HEARD

It is urged that persons and organizations having a common position make every effort to designate one spokeman to represent them in order for the Committee to hear as many points of view as possible. Time for oral presentation will be limited with the understanding that a more detailed statement may be included in the printed record of the hearing. This process will afford more time for Committee members to interrogate witnesses. The witnesses will be grouped as panels to expedite the hearing, and strict time limitations will be established for each panelist.

The following is an outline of the procedure to be followed by organizations and individuals who either may want to appear and testify during this hearing or file written statements for the printed record of the proceedings. All requests should contain the following information:

1. The name of the witness, his title, address, firm affiliation and/or organization he will represent (as well as a telephone number where he or his designated representative may be reached).

2. If appearing in an individual capacity, a list of any clients at whose request or in whose employ the witness appears.

3. A topical outline or summary of comments and recommendations.

Requests to be heard must be made by telephone to Harriett Lawler [telephone (202) 225-3627] by the close of business, Wednesday, June 9, 1982. The telephone request should be followed by a formal written request addressed to John J. Salmon, Chief Counsel, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515.

In order to assure the most productive use of the limited amount of time available to question hearing witnesses, witnesses scheduled to appear before the Subcommittee should comply with the following rules:

1. All witnesses must submit 75 copies of their prepared statements to the full Committee office, room 1102 Longworth House Office Building, not later than noon, Friday, June 11, 1982.

2. Witnesses should not read their written statements to the Subcommittee, but should instead limit their oral presentations to a summary of the points included in the statement.

3. Not more than five minutes will be allowed for the oral summary.

Failure to comply with these rquirements may result in the witnesses being denied the opportunity to testify in person or being deferred until all other testimony is heard.

WRITTEN STATEMENTS IN LIEU OF PERSONAL APPEARANCE

For those who wish to file a written statement for the printed record of the hearing, five copies are required and must be received by the close of business, Monday, June 21, 1982. The statements should be delivered to John J. Salmon, Chief counsel, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. An additional supply of statements for the printed record may be furnished for distribution to the press and public if supplied to the Committee office during the course of the hearing.

I

97TH CONGRESS
2D SESSION

H. R. 6055

To revise subchapter S of the Internal Revenue Code of 1954 (relating to small business corporations).

IN THE HOUSE OF REPRESENTATIVES

APRIL 1, 1982

Mr. ROSTENKOWSKI (for himself and Mr. CONABLE) introduced the following bill; which was referred to the Committee on Ways and Means

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A BILL

To revise subchapter S of the Internal Revenue Code of 1954 (relating to small business corporations).

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE; AMENDMENT OF 1954 CODE.

(a) SHORT TITLE.—This Act may be cited as the "Subchapter S Revision Act of 1982".

(b) AMENDMENT OF 1954 CODE.—Except as otherwise expressly provided, whenever in this Act an amendment or repeal is expressed in terms of an amendment to, or repeal of, a section or other provision, the reference shall be considered to be made to a section or other provision of the Internal Revenue Code of 1954.

SEC. 2. AMENDMENT OF SUBCHAPTER S.

Subchapter S of chapter 1 is amended to read as follows:

"Subchapter S—Tax Treatment of S Corporations and Their Shareholders

"Part I. In general.
"Part II. Tax treatment of shareholders.
"Part III. Special rules.
"Part IV. Definitions; miscellaneous.

"PART I—IN GENERAL

"Sec. 1361. S corporation defined.
"Sec. 1362. Election; revocation; termination.
"Sec. 1363. Effect of election on corporation.

"SEC. 1361. S CORPORATION DEFINED.

"(a) S CORPORATION DEFINED.—

"(1) IN GENERAL.—For purposes of this title, the term 'S corporation' means, with respect to any taxable year, a small business corporation for which an election under section 1362(a) is in effect for such year.

"(2) C CORPORATION.—For purposes of this title, the term 'C corporation' means, with respect to any taxable year, a corporation which is not an S corporation for such year.

"(b) SMALL BUSINESS CORPORATION.—

"(1) IN GENERAL.—For purposes of this subchapter, the term 'small business corporation' means a domestic corporation which is not an ineligible corporation and which does not—

"(A) have more than 35 shareholders,

"(B) have as a shareholder a person (other than an estate and other than a trust described in subsection (c)(2)) who is not an individual,

"(C) have a nonresident alien as a shareholder, and

"(D) have more than 1 class of stock.

"(2) INELIGIBLE CORPORATION DEFINED.—For purposes of paragraph (1), the term 'ineligible corporation' means any corporation which is—

"(A) a member of an affiliated group (determined under section 1504 without regard to the exceptions contained in subsection (b) thereof),

"(B) a financial institution to which section 585 or 593 applies,

"(C) an insurance company subject to tax under subchapter L,

"(D) a corporation to which an election under section 936 applies, or

"(E) a DISC or former DISC.

"(c) SPECIAL RULES FOR APPLYING SUBSECTION (b).—

"(1) HUSBAND AND WIFE TREATED AS 1 SHAREHOLDER.—For purposes of subsection (b)(1)(A), a husband and wife (and their estates) shall be treated as 1 shareholder.

"(2) CERTAIN TRUSTS PERMITTED AS SHAREHOLDERS.—

"(A) IN GENERAL.—For purposes of subsection (b)(1)(B), the following trusts may be shareholders:

"(i) A trust all of which is treated (under subpart E of part I of subchapter J of this chapter) as owned by an individual who is a citizen or resident of the United States.

"(ii) A trust which was described in clause (i) immediately before the death of the deemed owner and which continues in existence after such death, but only for the 60-day period beginning on the day of the deemed owner's death. If a trust is described in the preceding sentence and if the entire corpus of the trust is includible in the gross estate of the deemed owner, the preceding sentence shall be applied by substituting '2-year period' for '60-day period'.

"(iii) A trust with respect to stock transferred to it pursuant to the terms of a will, but only for the 60-day period beginning on the day on which such stock is transferred to it.

"(iv) A trust created primarily to exercise the voting power of stock transferred to it.

This subparagraph shall not apply to any foreign trust.

"(B) TREATMENT AS SHAREHOLDERS.—For purposes of subsection (b)(1)(A)—

"(i) In the case of a trust described in clause (i) of subparagraph (A), the deemed owner shall be treated as the shareholder.

"(ii) In the case of a trust described in clause (ii) of subparagraph (A), the estate of the deemed owner shall be treated as the shareholder.

"(iii) In the case of a trust described in clause (iii) of subparagraph (A), the estate of the testator shall be treated as the shareholder.

"(iv) In the case of a trust described in clause (iv) of subparagraph (A), each beneficiary of the trust shall be treated as a shareholder.

"(3) ESTATE OF INDIVIDUAL IN BANKRUPTCY MAY BE SHAREHOLDER.—For purposes of subsection (b)(1)(B), the term 'estate' includes the estate of an individual in a case under title 11 of the United States Code.

"(4) DIFFERENCES IN COMMON STOCK VOTING RIGHTS DISREGARDED.—For purposes of subsection (b)(1)(D), a corporation shall not be treated as having more than 1 class of stock solely because there are differences in voting rights among the shares of common stock.

"(5) OWNERSHIP OF STOCK IN CERTAIN INACTIVE CORPORATIONS.—For purposes of subsection (b)(2)(A), a corporation shall not be treated as a member of an affiliated group at any time during any taxable year by reason of the ownership of stock in another corporation if such other corporation—

"(A) has not begun business at any time on or after the date of its incorporation and before the close of such taxable year, and

"(B) does not have taxable income for the period included within such taxable year.

"(d) SPECIAL RULE FOR QUALIFIED SUBCHAPTER S TRUST.—

"(1) IN GENERAL.—In the case of a qualified subchapter S trust with respect to which a beneficiary makes an election under paragraph (2)—

"(A) such trust shall be treated as a trust described in subsection (c)(2)(A)(i), and

"(B) for purposes of section 678(a), the beneficiary of such trust shall be treated as the owner of that portion of the trust which consists of stock in an S corporation with respect to which the election under paragraph (2) is made.

"(2) ELECTION.—

"(A) IN GENERAL.—A beneficiary of a qualified subchapter S trust (or his legal representative) may elect to have this subsection apply.

"(B) MANNER AND TIME OF ELECTION.— An election under this paragraph shall be made—

"(i) separately with respect to each S corporation the stock of which is held by the trust, "(ii) separately with respect to each successive income beneficiary of the trust, and

"(iii) in such manner and form, and at such time, as the Secretary may prescribe.

"(C) ELECTION IRREVOCABLE.—An election under this paragraph, once made, may be revoked only with the consent of the Secretary.

"(D) GRACE PERIOD.—An election under this paragraph shall be effective up to 60 days before the date of the election.

"(3) QUALIFIED SUBCHAPTER S TRUST.—For purposes of this subsection, the term 'qualified subchapter S trust' means a trust—

"(A) which owns stock in 1 or more S corporations,

"(B) all of the income (within the meaning of section 643(b)) of which is distributed (or required to be distributed) currently to 1 individual who is a citizen, or

"(C) the terms of which require that—

"(i) at any time, there shall be only 1 income beneficiary of the trust, "(ii) any corpus distributed during the term of the trust may be distributed only to the current income beneficiary thereof,

"(iii) each income interest in the trust shall terminate on the earlier of the death of the income beneficiary or the termination of the trust, and

"(iv) upon the termination of the trust during the life of an income beneficiary, the trust shall distribute all of its assets to such income beneficiary.

"(4) TRUST CEASING TO BE QUALIFIED.—If a qualified subchapter S trust ceases to meet any requirement under paragraph (3), the provisions of this subsection shall not apply to such trust as of the date it ceases to meet such requirements.

"SEC. 1362. ELECTION; REVOCATION; TERMINATION.

"(a) ELECTION.—

"(1) IN GENERAL.—Except as provided in subsection (g), a small business corporation may elect, in accordance with the provisions of this section, to be an S corporation.

"(2) ALL SHAREHOLDERS MUST CONSENT TO ELECTION.—An election under this subsection shall be valid only if all persons who are shareholders in such corporation on the day on which such election is made consent to such election.

"(b) WHEN MADE.—

"(1) IN GENERAL.—An election under subsection (a) may be made by a small business corporation for any taxable year—

"(A) at any time during the preceding taxable year, or

"(B) at any time during the taxable year and on or before the 15th day of the 3d month of the taxable year.

"(2) CERTAIN ELECTIONS MADE DURING 1ST 2½ MONTHS TREATED AS MADE FOR NEXT TAXABLE YEAR.—If—

"(A) an election under subsection (a) is made for any taxable year during such year and on or before the 15th day of the 3d month of such year, but

"(B) either—

"(i) on 1 or more days in such taxable year before the day on which the election was made the corporation did not meet the requirements of subsection (b) of section 1361, or "(ii) 1 or more of the persons who held stock in the corporation during such taxable year and before the election was made did not consent to the election,

then such election shall be treated as made for the following taxable year.

"(3) ELECTION MADE AFTER 1ST 2½ MONTHS TREATED AS MADE FOR FOLLOWING TAXABLE YEAR.—If—

"(A) a small business corporation makes an election under subsection (a) for any taxable year, and

"(B) such election is made after the 15th day of the 3d month of the taxable year and on or before the last day of such taxable year,

then such election shall be treated as made for the following taxable year.

"(c) YEARS FOR WHICH EFFECTIVE.—An election under subsection (a) shall be effective for the taxable year of the corporation for which it is made and for all succeeding taxable years of the corporation, until such election is terminated under subsection (d).

"(d) TERMINATION.—

"(1) BY REVOCATION.—

"(A) IN GENERAL.—An election under subsection (a) may be terminated by revocation.

"(B) ONE-HALF OF SHAREHOLDERS MUST CONSENT TO REVOCATION.—An election may be revoked only if shareholders holding more than one-half of the shares of stock of the corporation on the day on which the revocation is made consent to the revocation.

"(C) WHEN EFFECTIVE.—Except as provided in subparagraph (D)—

"(i) a revocation made during the taxable year and on or before the 15th day of the 3d month thereof shall be effective on the 1st day of such taxable year, and

"(ii) a revocation made during the taxable year but after such 15th day shall be effective on the 1st day of the following taxable year.

"(D) REVOCATION MAY SPECIFY PROSPECTIVE DATE.—If the revocation specifies a date for revocation which is on or after the day on which the revocation is made, the revocation shall be effective on and after the date so specified.

"(2) BY CORPORATION CEASING TO BE SMALL BUSINESS CORPORATION.—

"(A) IN GENERAL.—An election under subsection (a) shall be terminated whenever (at any time on or after the 1st day of the 1st taxable year for which the corporation is an S corporation) such corporation ceases to be a small business corporation.

"(B) WHEN EFFECTIVE.—Any termination under this paragraph shall be effective on and after the date of cessation.

"(3) WHERE PASSIVE INVESTMENT INCOME EXCEEDS 20 PERCENT OF GROSS RECEIPTS AND CORPORATION HAS ACCUMULATED EARNINGS AND PROFITS.—

"(A) TERMINATION.—

"(i) IN GENERAL.—An election under subsection (a) shall be terminated whenever the corporation—

"(I) has gross receipts for any taxable year more than 20 percent of which is passive investment income, and

"(II) has accumulated earnings and profits at the close of such taxable year.

"(ii) WHEN EFFECTIVE.—Any termination under this paragraph shall be effective on and after the first day of the taxable year referred to in clause (i).

"(B) EXCEPTION.—Subparagraph (A) shall not apply with respect to a taxable year if—

"(i) such taxable year is the first taxable year in which the corporation commenced the active conduct of any trade or business or the next succeeding taxable year, and

"(ii) the amount of passive investment income for such taxable year is less than $3,000.

"(C) PASSIVE INVESTMENT INCOME DEFINED.—For purposes of this paragraph, the term 'passive investment income' means gross receipts derived from royalties, rents, dividends, interest, annuities, and sales or exchanges of stock or securities (gross receipts from such sales or exchanges being taken into account for purposes of this paragraph only to the extent of gains therefrom). Gross receipts derived from sales or exchanges of stock or securities for purposes of this paragraph shall not include amounts received by an S corporation which are treated under section 331 (relating to corporate liquidations) as payments in exchange for stock where the S corporation owned more than 50 percent of each class of the stock of the liquidating corporation.

"(4) Foreign income.—

"(A) Termination.—An election under subsection (a) shall be terminated whenever the corporation derives more than 80 percent of its gross receipts for any taxable year from sources without the United States.

"(B) When effective.—Any termination under this paragraph shall be effective on and after the first day of the taxable year referred to in subparagraph (A).

"(e) Treatment of S Termination Year.—

"(1) In general.—In the case of an S termination year, for purposes of this title—

"(A) S short year.—The portion of such year ending before the 1st day for which the termination is effective shall be treated as a short taxable year for which the corporation is an S corporation.

"(B) C short year.—The portion of such year beginning on such 1st day shall be treated as a short taxable year for which the corporation is a C corporation.

"(2) PRO RATA ALLOCATION.—Except as provided in paragraph (3), the determination of which items are to be taken into account for each of the short taxable years referred to in paragraph (1) shall be made—

"(A) first by determining for the S termination year—

"(i) the amount of each of the items of income, loss, deduction, or credit described in section 1366(a)(1)(A), and

"(ii) the amount of the nonseparately computed income or loss, and

"(B) then by assigning an equal portion of each amount determined under subparagraph (A) to each day of the S termination year.

"(3) ELECTION TO HAVE ITEMS ASSIGNED TO EACH SHORT TAXABLE YEAR UNDER NORMAL TAX ACCOUNTING RULES.—

"(A) IN GENERAL.—A corporation may elect to have paragraph (2) not apply.

"(B) ALL SHAREHOLDERS MUST CONSENT TO ELECTION.—An election under this paragraph shall be valid only if all persons who are shareholders in the corporation at any time during the S termination year consent to such election.

"(4) S TERMINATION YEAR.—For purposes of this subsection, the term 'S termination year' means any taxable year of a corporation in which a termination of an election made under subsection (a) takes effect (other than on the 1st day thereof).

"(5) TAX FOR C SHORT YEAR DETERMINED ON ANNUALIZED BASIS.—

"(A) IN GENERAL.—The taxable income for the short year described in subparagraph (B) of paragraph (1) shall be placed on an annual basis by multiplying the taxable income for such short year by the number of days in the S termination year and by dividing the result by the number of days in the short year. The tax shall be the same part of the tax computed on the annual basis as the number of days in such short year is of the number of days in the S termination year.

"(B) SECTION 443(d)(2) TO APPLY.—Subsection (d)(2) of section 443 shall apply to the short taxable year described in subparagraph (B) of paragraph (1).

"(6) OTHER SPECIAL RULES.—For purposes of this title—

"(A) SHORT YEARS TREATED AS 1 YEAR FOR CARRYOVER PURPOSES.—The short taxable year described in subparagraph (A) of paragraph (1) shall not be taken into account for purposes of determining the number of taxable years to which any item may be carried back or carried forward by the corporation.

"(B) DUE DATE FOR S YEAR.—The due date for filing the return for the short taxable year described in subparagraph (A) of paragraph (1) shall be the same as the due date for filing the return for the short taxable year described in subparagraph (B) of paragraph (1) (including extensions thereof).

"(f) INADVERTENT TERMINATIONS.—If—

"(1) an election under subsection (a) by any corporation was terminated under paragraph (2), (3), or (4) of subsection (d),

"(2) the Secretary determines that the termination was inadvertent,

"(3) no later than a reasonable period of time after discovery of the event resulting in such termination, steps were taken so that the corporation is once more a small business corporation, and

"(4) the corporation, and each person who was a shareholder of the corporation at any time during the period specified pursuant to this subsection, agrees to make such adjustments (consistent with the treatment of the corporation as an S corporation) as may be required by the Secretary with respect to such period, then, notwithstanding the terminating event, such corporation shall be treated as continuing to be an S corporation during the period specified by the Secretary.

"(g) ELECTION AFTER TERMINATION.—If a small business corporation has made an election under subsection (a) and if such election has been terminated under subsection (d), such corporation (and any successor corporation) shall not be eligible to make an election under subsection (a) for any taxable year before its 5th taxable year which begins after the 1st taxable year for which such termination is effective, unless the Secretary consents to such election.

"SEC. 1363. EFFECT OF ELECTION ON CORPORATION.

"(a) GENERAL RULE.—Except as otherwise provided in this subchapter and in section 58(d), an S corporation shall not be subject to the taxes imposed by this chapter.

"(b) COMPUTATION OF CORPORATION'S TAXABLE INCOME.—The taxable income of an S corporation shall be computed in the same manner as in the case of an individual, except that—

"(1) the items described in section 1366(a)(1)(A) shall be separately stated, "(2) the deductions referred to in section 703(a)(2) shall not be allowed to the corporation, and

"(3) section 248 shall apply.

"(c) Elections of the S Corporation.—

"(1) In general.—Except as provided in paragraph (2), any election affecting the computation of items derived from an S corporation shall be made by the corporation.

"(2) Exceptions.—In the case of an S corporation, elections under the following provisions shall be made by each shareholder separately—

"(A) subsection (b)(5) or (d)(4) of section 108 (relating to income from discharge of indebtedness),

"(B) section 163(d) (relating to limitation on interest on investment indebtedness),

"(C) section 617 (relating to deduction and recapture of certain mining exploration expenditures), and

"(D) section 901 (relating to taxes of foreign countries and possessions of the United States).

"(d) Distributions of Appreciated Property.—

"(1) In general.—If—

"(A) an S corporation makes a distribution of property (other than an obligation of such corporation) with respect to its stock, and

"(B) the fair market value of such property exceeds its adjusted basis in the hands of the S corporation,

then gain shall be recognized to the S corporation on the distribution in the same manner as if it had sold such property to the distributee at its fair market value.

"(2) COORDINATION WITH SECTION 311.—Proper adjustment shall be made in the gain recognized under paragraph (1) for any gain recognized under section 311.

"(3) PARTIAL LIQUIDATIONS TREATED LIKE DISTRIBUTIONS.—For purposes of this subsection and sections 311 and 336, a distribution of property in partial liquidation of an S corporation (other than a distribution described in paragraph (1) of section 346(a)) shall be treated as a distribution with respect to the stock of such corporation.

"PART II—TAX TREATMENT OF SHAREHOLDERS

"Sec. 1366. Pass-thru of items to shareholders.
"Sec. 1367. Adjustments to basis of stock of shareholders, etc.
"Sec. 1368. Distributions.

"SEC. 1366. PASS-THRU OF ITEMS TO SHAREHOLDERS.

"(a) Determination of Shareholder's Tax Liability.—

"(1) In general.—In determining the tax under this chapter of a shareholder for the shareholder's taxable year in which the taxable year of the S corporation ends, there shall be taken into account the shareholder's pro rata share of the corporation's—

"(A) items of income (including tax-exempt income), loss, deduction, or credit the separate treatment of which could affect the liability for tax of any shareholder, and

"(B) nonseparately computed income or loss.

"(2) Nonseparately computed income or loss defined.—For purposes of this subchapter, the term 'nonseparately computed income or loss' means gross income minus the deductions allowed to the corporation under this chapter, determined by excluding all items described in paragraph (1)(A).

"(b) Character Passed Thru.—The character of any item included in a shareholder's pro rata share under paragraph (1) of subsection (a) shall be determined as if such item were realized directly from the source from which realized by the corporation, or incurred in the same manner as incurred by the corporation.

"(c) GROSS INCOME OF A SHAREHOLDER.—In any case where it is necessary to determine the gross income of a shareholder for purposes of this title, such gross income shall include the shareholder's pro rata share of the gross income of the corporation.

"(d) SPECIAL RULES FOR LOSSES AND DEDUCTIONS.—

"(1) CANNOT EXCEED SHAREHOLDER'S BASIS IN STOCK AND DEBT.—The aggregate amount of losses and deductions taken into account by a shareholder under subsection (a) for any taxable year shall not exceed the sum of—

"(A) the adjusted basis of the shareholder's stock in the S corporation (determined with regard to paragraph (1) of section 1367(a) for the taxable year), and

"(B) the shareholder's adjusted basis of any indebtedness of the S corporation to the shareholder (determined without regard to any adjustment under paragraph (2) of section 1367(b) for the taxable year).

"(2) INDEFINITE CARRYOVER OF DISALLOWED LOSSES AND DEDUCTIONS.—Any loss or deduction which is disallowed for any taxable year by reason of paragraph (1) shall be treated as incurred by the corporation in the succeeding taxable year with respect to that shareholder.

"(3) CARRYOVER OF DISALLOWED LOSSES AND DEDUCTIONS TO POST-TERMINATION TRANSITION PERIOD.—

"(A) IN GENERAL.—If for the last taxable year of a corporation for which it was an S corporation a loss or deduction was disallowed by reason of paragraph (1), such loss or deduction shall be treated as incurred by the shareholder on the last day of any post-termination transition period.

"(B) CANNOT EXCEED SHAREHOLDER'S BASIS IN STOCK.—The aggregate amount of losses and deductions taken into account by a shareholder under subparagraph (A) shall not exceed the adjusted basis of the shareholder's stock in the corporation (determined at the close of the last day of the post-termination transition period and without regard to this paragraph).

"(C) ADJUSTMENT IN BASIS OF STOCK.—The shareholder's basis in the stock of the corporation shall be reduced by the amount allowed as a deduction by reason of this paragraph.

"(e) TREATMENT OF FAMILY GROUP.—If an individual who is a member of the family (within the meaning of section 704(e)(3)) of one or more shareholders of an S corporation renders services for the corporation or furnishes capital to the corporation without receiving reasonable compensation therefor, the Secretary shall make such adjustments in the items taken into account by such individual and such shareholders as may be necessary in order to reflect the value of such services or capital.

"(f) SPECIAL RULES.—

"(1) SECTION NOT TO APPLY TO CREDIT ALLOWABLE UNDER SECTION 39.—Subsection (a) shall not apply with respect to any credit allowable under section 39 (relating to certain uses of gasoline, special fuels, and lubricating oil).

"(2) REDUCTION IN PASS-THRU FOR TAX IMPOSED ON CAPITAL GAIN.—If any tax is imposed under section 56 or 1374 for any taxable year on an S corporation, for purposes of subsection (a)—

"(A) the amount of the corporation's long-term capital gains for the taxable year shall be reduced by the amount of such tax, and

"(B) if the amount of such tax exceeds the amount of such long-term capital gains, the corporation's gains from sales or exchanges of property described in section 1231 shall be reduced by the amount of such excess.

For purposes of the preceding sentence, the term 'long-term capital gain' shall not include any gain from the sale or exchange of property described in section 1231.

"SEC. 1367. ADJUSTMENTS TO BASIS OF STOCK OF SHAREHOLDERS, ETC.

"(a) GENERAL RULE.—

"(1) INCREASES IN BASIS.—The basis of each shareholder's stock in an S corporation shall be increased for any period by the sum of the following items determined with respect to that shareholder for such period:

"(A) the items of income described in subparagraph (A) of section 1366(a)(1),

"(B) any nonseparately computed income determined under subparagraph (B) of section 1366(a)(1), and

"(C) the excess of the deductions for depletion over the basis of the property subject to depletion.

"(2) DECREASES IN BASIS.—The basis of each shareholder's stock in an S corporation shall be decreased for any period (but not below zero) by the sum of the following items determined with respect to the shareholder for such period:

"(A) distributions by the corporation which were not includible in the income of the shareholder by reason of section 1368,

"(B) the items of loss and deduction described in subparagraph (A) of section 1366(a)(1),

"(C) any nonseparately computed loss determined under subparagraph (B) of section 1366(a)(1),

"(D) any expense of the corporation not deductible in computing its taxable income and not properly chargeable to capital account, and

"(E) the amount of the shareholder's deduction for depletion under section 611 with respect to oil and gas wells.

"(b) SPECIAL RULES.—

"(1) INCOME ITEMS.—An amount which is required to be included in the gross income of a shareholder and shown on his return shall be taken into account under subparagraph (A) or (B) of subsection (a)(1) only to the extent such amount is included in the shareholder's gross income on his return, increased or decreased by any adjustment of such amount in a redetermination of the shareholder's tax liability.

"(2) ADJUSTMENTS IN BASIS OF INDEBTEDNESS.—

"(A) REDUCTION OF BASIS.—If for any taxable year the amounts specified in subparagraphs (B), (C), (D), and (E) of subsection (a)(2) exceed the amount which reduces the shareholder's basis to zero, such excess shall be applied to reduce (but not below zero) the shareholder's basis in any indebtedness of the S corporation to the shareholder.

"(B) RESTORATION OF BASIS.—If for any taxable year there is a reduction under subparagraph (A) in the shareholder's basis in the indebtedness of an S corporation to a shareholder, any net increase (after the application of paragraphs (1) and (2) of subsection (a)) for any subsequent taxable year shall be applied to restore such reduction in basis before any of it may be used to increase the shareholder's basis in the stock of the S corporation.

"(3) COORDINATION WITH SECTION 165(g).—This section and section 1366 shall be applied before the application of section 165(g) to any taxable year of the shareholder in which the stock becomes worthless.

"SEC. 1368. DISTRIBUTIONS.

"(a) GENERAL RULE.—A distribution of property made by an S corporation with respect to its stock to which (but for this subsection) section 301(c) would apply shall be treated in the manner provided in subsection (b) or (c), whichever applies.

"(b) S CORPORATION HAVING NO EARNINGS AND PROFITS.—In the case of a distribution described in subsection (a) by an S corporation which has no accumulated earnings and profits—

"(1) AMOUNT APPLIED AGAINST BASIS.—The distribution shall not be included in gross income to the extent that it does not exceed the adjusted basis of the stock.

"(2) AMOUNT IN EXCESS OF BASIS.—If the amount of the distribution exceeds the adjusted basis of the stock, such excess shall be treated as gain from the sale or exchange of property.

"(c) S CORPORATION HAVING EARNINGS AND PROFITS.—In the case of a distribution described in subsection (a) by an S corporation which has accumulated earnings and profits—

"(1) ACCUMULATED ADJUSTMENTS ACCOUNT.—That portion of the distribution which does not exceed the accumulated adjustments account shall be treated in the manner provided by subsection (b).

"(2) DIVIDEND.—That portion of the distribution which remains after the application of paragraph (1) shall be treated as a dividend to the extent it does not exceed the accumulated earnings and profits of the S corporation.

"(3) TREATMENT OF REMAINDER.—Any portion of the distribution remaining after the application of paragraph (2) of this subsection shall be treated in the manner provided by subsection (b).

"(d) CERTAIN ADJUSTMENTS TAKEN INTO ACCOUNT.—Subsections (b) and (c) shall be applied by taking into account (to the extent proper)—

"(1) the adjustments to the basis of the shareholder's stock described in section 1367, and

"(2) the adjustments to the accumulated adjustments account which are required by subsection (e)(1).

"(e) DEFINITIONS AND SPECIAL RULES.—For purposes of this section—

"(1) ACCUMULATED ADJUSTMENTS ACCOUNT.—

"(A) IN GENERAL.—Except as provided in subparagraph (B), the term 'accumulated adjustments account' means an account of the S corporation which is adjusted for the S period in a manner similar to the adjustments under section 1367 (except that no adjustment shall be made for income which is exempt from tax under this title and no adjustment shall be made for any expense not deductible in computing the corporation's taxable income and not properly chargeable to capital account).

"(B) AMOUNT OF ADJUSTMENT IN THE CASE OF REDEMPTIONS, ETC.—In the case of any partial liquidation or of any redemption which is treated as an exchange under section 302(a) or 303(a), the adjustment in the accumulated adjustments account shall be an amount which bears the same ratio to the balance in such account as the number of shares redeemed in such redemption bears to the number of shares of stock in the corporation immediately before such redemption.

"(2) S PERIOD.—The term 'S period' means the most recent continuous period during which the corporation has been an S corporation. Such period shall not include any taxable year beginning before January 1, 1983.

"PART III—SPECIAL RULES

"Sec. 1371. Coordination with subchapter C.
"Sec. 1372. Coordination with part I of subchapter D, etc.
"Sec. 1373. Foreign income.
"Sec. 1374. Tax imposed on certain capital gains.
"Sec. 1375. Administration.

"SEC. 1371. COORDINATION WITH SUBCHAPTER C.

"(a) APPLICATION OF SUBCHAPTER C RULES.—

"(1) IN GENERAL.—Except as otherwise provided in this title, and except to the extent inconsistent with this subchapter, subchapter C shall apply to an S corporation and its shareholders.

"(2) S CORPORATION AS SHAREHOLDER TREATED LIKE INDIVIDUAL.—For purposes of subchapter C, an S corporation in its capacity as a shareholder of another corporation shall be treated as an individual.

"(b) NO CARRYOVER BETWEEN C YEAR AND S YEAR.—

"(1) FROM C YEAR TO S YEAR.—No carryforward, and no carryback, arising for a taxable year for which a corporation is a C corporation may be carried to a taxable year for which such corporation is an S corporation.

"(2) NO CARRYOVER FROM S YEAR.—No carryforward, and no carryback, shall arise at the corporate level for a taxable year for which a corporation is an S corporation.

"(3) TREATMENT OF S YEAR AS ELAPSED YEAR.—Nothing in paragraphs (1) and (2) shall prevent treating a taxable year for which a corporation is an S corporation as a taxable year for purposes of determining the number of taxable years to which an item may be carried back or carried forward.

"(c) EARNINGS AND PROFITS.—

"(1) IN GENERAL.—Except as provided in paragraphs (2) and (3), no adjustment shall be made to the earnings and profits of an S corporation.

"(2) ADJUSTMENTS FOR REDEMPTIONS, LIQUIDATIONS, REORGANIZATIONS, DIVISIVES, ETC.—In the case of any transaction involving the application of subchapter C to any S corporation, proper adjustment to any accumulated earnings and profits of the corporation shall be made.

"(3) ADJUSTMENTS IN CASE OF DISTRIBUTIONS TREATED AS DIVIDENDS UNDER SECTION 1368(C)(2).—Paragraph (1) shall not apply with respect to that portion of a distribution which is treated as a dividend under section 1368(c)(2).

"(d) COORDINATION WITH INVESTMENT CREDIT RECAPTURE.—

"(1) NO RECAPTURE BY REASON OF ELECTION.—Any election under section 1362 shall be treated as a mere change in the form of conducting a trade or business for purposes of the second sentence of section 47(b).

"(2) CORPORATION CONTINUES TO BE LIABLE.—Notwithstanding an election under section 1362, an S corporation shall continue to be liable for any increase in tax under section 47 attributable to credits allowed for taxable years for which such corporation was not an S corporation.

"(e) CASH DISTRIBUTIONS DURING POST-TERMINATION TRANSITION PERIOD.—Any distribution of money by a corporation with respect to its stock during a post-termination transition period shall be applied against and reduce the adjusted basis of the stock, to the extent that the amount of the distribution does not exceed the accumulated adjustments account.

"SEC. 1372. COORDINATION WITH PART I OF SUBCHAPTER D, ETC.

"(a) PARTNERSHIP RULES TO APPLY FOR DEFERRED COMPENSATION PURPOSES.—For purposes of part I of subchapter D (and all other provisions of this title which relate to deferred compensation with respect to owner-employees or employees within the meaning of section 401(c)(1))—

"(1) any 2-percent shareholder of an S corporation who is an employee of such corporation—

"(A) shall be treated as an employee within the meaning of section 401(c)(1), and

"(B) if such shareholder is a 10-percent shareholder, shall be treated as an owner-employee within the meaning of section 401(c)(3), and

"(2) compensation received or accrued by such shareholder from the corporation shall be treated as earned income.

"(b) PERCENTAGE SHAREHOLDERS DEFINED.—

"(1) 2-PERCENT SHAREHOLDER.—For purposes of this section, the term '2-percent shareholder' means any person who owns (or is considered as owning within the meaning of section 318) on any day during the taxable year of the S corporation more than 2 percent of the outstanding stock of such corporation or stock possessing more than 2 percent of the total combined voting power of all stock of such corporation.

"(2) 10-PERCENT SHAREHOLDER.—For purposes of this section, the term '10-percent shareholder' means a person who would be described in paragraph (1) if '10 percent' were substituted for '2 percent' each place it appears therein.

"(c) PARTNERSHIP RULES TO APPLY FOR FRINGE BENEFIT PURPOSES.—For purposes of applying the provisions of this subtitle which relate to employee fringe benefits—

"(1) the S corporation shall be treated as a partnership, and

"(2) any 2-percent shareholder of the S corporation shall be treated as a partner of such partnership.

"SEC. 1373. FOREIGN INCOME.

"(a) S CORPORATION TREATED AS PARTNERSHIP, ETC.—For purposes of subparts A and F of part III, and part V, of subchapter N (relating to income from sources without the United States)—

"(1) an S corporation shall be treated as a partnership, and

"(2) the shareholders of such corporation shall be treated as partners of such partnership.

"(b) RECAPTURE OF OVERALL FOREIGN LOSS.—For purposes of section 904(f) (relating to recapture of overall foreign loss), the making or termination of an election to be treated as an S corporation shall be treated as a disposition of the business.

"SEC. 1374. TAX IMPOSED ON CERTAIN CAPITAL GAINS.

"(a) GENERAL RULE.—If for a taxable year of an S corporation—

"(1) the net capital gain of such corporation exceeds $25,000, and exceeds 50 percent of its taxable income for such year, and

"(2) the taxable income of such corporation for such year exceeds $25,000,

there is hereby imposed a tax (computed under subsection (b)) on the income of such corporation.

"(b) AMOUNT OF TAX.—The tax imposed by subsection (a) shall be the lower of—

"(1) an amount equal to the tax, determined as provided in section 1201(a), on the amount by which the net capital gain of the corporation for the taxable year exceeds $25,000, or

"(2) an amount equal to the tax which would be imposed by section 11 on the taxable income of the corporation for the taxable year if the corporation were not an S corporation.

No credit shall be allowable under part IV of subchapter A of this chapter (other than under section 39) against the tax imposed by subsection (a).

"(c) EXCEPTIONS.—

"(1) IN GENERAL.—Subsection (a) shall not apply to an S corporation for any taxable year if the election under section 1362(a) which is in effect with respect to such corporation for such taxable year has been in effect for the 3 immediately preceding taxable years.

"(2) NEW CORPORATIONS.—Subsection (a) shall not apply to an S corporation if—

"(A) it (and any predecessor corporation) has been in existence for less than 4 taxable years, and

"(B) an election under section 1362(a) has been in effect with respect to such corporation for each of its taxable years.

"(3) PROPERTY WITH SUBSTITUTED BASIS.—If—

"(A) but for paragraph (1) or (2), subsection (a) would apply for the taxable year,

"(B) any long-term capital gain is attributable to property acquired by the S corporation during the period beginning 3 years before the first day of the taxable year and ending on the last day of the taxable year, and

"(C) the basis of such property is determined in whole or in part by reference to the basis of any property in the hands of another corporation which was not an S corporation throughout all of the period described in subparagraph (B) before the transfer by such other corporation and during which such other corporation was in existence,

then subsection (a) shall apply for the taxable year, but the amount of the tax determined under subsection (b) shall not exceed a tax, determined as provided in section 1201(a), on the net capital gain attributable to property acquired as provided in subparagraph (B) and having a basis described in subparagraph (C).

"(d) DETERMINATION OF TAXABLE INCOME.—For purposes of subsections (a)(2) and (b)(2), taxable income of the corporation shall be determined under section 63(a) without regard to—

"(1) the deduction allowed by section 172 (relating to net operating loss deduction), and

"(2) the deductions allowed by part VII of subchapter B (other than the deduction allowed by section 248, relating to organization expenditures).

"SEC. 1375. ADMINISTRATION.

"(a) TAX TREATMENT DETERMINED AT CORPORATE LEVEL.—Except as otherwise provided in regulations prescribed by the Secretary, the tax treatment of any subchapter S item shall be determined at the corporate level.

"(b) SHAREHOLDER'S RETURN MUST BE CONSISTENT WITH CORPORATE RETURN OR SECRETARY NOTIFIED OF INCONSISTENCY.—A shareholder of an S corporation shall, on such shareholder's return, treat a subchapter S item in a manner which is consistent with the treatment of such item on the corporate return unless the shareholder notifies the Secretary (at the time and in the manner prescribed by regulations) of the inconsistency.

"(c) ALL SHAREHOLDERS TO BE NOTIFIED OF PROCEEDINGS AND GIVEN OPPORTUNITY TO PARTICIPATE.—In the manner and at the time prescribed in regulations, each shareholder in a subchapter S corporation shall be given notice of, and an opportunity to participate in, any administrative or judicial proceeding for the determination at the corporate level of any subchapter S item.

"(d) Secretary To Recommend Changes.—Within 120 days after the date of the enactment of this section, the Secretary shall recommend to the Committee on Ways and Means of the House of Representatives and to the Committee on Finance of the Senate—

"(1) such changes in the periods for assessing deficiencies, and for filing claims for credit or refund, with respect to subchapter S items,

"(2) such changes in the procedure for administrative and judicial determination of subchapter S items, and

"(3) such other changes in subtitle F with respect to subchapter S items,

as may be necessary or appropriate for the effective and efficient administration of this title with respect to subchapter S corporations and their shareholders.

"(e) Subchapter S Item Defined.—For purposes of this section, the term 'subchapter S item' means any item of income (including tax-exempt income), loss, deduction, or credit of an S corporation.

"PART IV—DEFINITIONS; MISCELLANEOUS

"Sec. 1377. Definitions and special rule.
"Sec. 1378. Taxable year of S corporation.
"Sec. 1379. Transitional rules on enactment.

"SEC. 1377. DEFINITIONS AND SPECIAL RULE.

"(a) PRO RATA SHARE.—For purposes of this subchapter—

"(1) IN GENERAL.—Except as provided in paragraph (2), each shareholder's pro rata share of any item for any taxable year shall be the sum of the amounts determined with respect to the shareholder—

"(A) by assigning an equal portion of such item to each day of the taxable year, and

"(B) then by dividing that portion pro rata among the shares outstanding on such day.

"(2) ELECTION TO TERMINATE YEAR.—Under regulations prescribed by the Secretary, if any shareholder terminates his interest in the corporation during the taxable year and all persons who are shareholders during the taxable year agree to the application of this paragraph, paragraph (1) shall be applied as if the taxable year consisted of 2 taxable years the first of which ends on the date of the termination.

"(b) POST-TERMINATION TRANSITION PERIOD.—

"(1) IN GENERAL.—For purposes of this subchapter, the term 'post-termination transition period' means—

"(A) the period beginning on the day after the last day of the corporation's last taxable year as an S corporation and ending on the later of—

"(i) the day which is 1 year after such last day, or

"(ii) the due date for filing the return for such last year as an S corporation (including extensions), and

"(B) the 120-day period beginning on the date of a determination that the corporation's election under section 1362(a) had terminated for a previous taxable year.

"(2) DETERMINATION DEFINED.—For purposes of paragraph (1), the term 'determination' means—

"(A) a court decision which becomes final,

"(B) a closing agreement, or

"(C) an agreement between the corporation and the Secretary that the corporation failed to qualify as an S corporation.

"(c) MANNER OF MAKING ELECTIONS, ETC.—Any election under this subchapter, and any revocation under section 1362(d)(1), shall be made in such manner as the Secretary shall by regulations prescribe.

"SEC. 1378. TAXABLE YEAR OF S CORPORATION.

"(a) GENERAL RULE.—For purposes of this subtitle—

"(1) an S corporation shall not change its taxable year to any accounting period other than a permitted year, and

"(2) no corporation may make an election under section 1362(a) for any taxable year unless such taxable year is a permitted year.

"(b) Permitted Year Defined.—For purposes of this section, the term 'permitted year' means a taxable year which—

"(1) is a year ending December 31, or

"(2) is any other accounting period for which the corporation establishes a business purpose to the satisfaction of the Secretary.

"(c) Existing S Corporations Required To Use Permitted Year After 50-Percent Shift in Ownership.—

"(1) In general.—A corporation which is an S corporation for a taxable year which includes December 31, 1982, shall not be treated as an S corporation for any subsequent taxable year beginning after the first day on which more than 50 percent of the stock is newly owned stock unless such subsequent taxable year is a permitted year.

"(2) Newly owned stock.—For purposes of paragraph (1), the stock held by any person on any day shall be treated as newly owned stock to the extent that—

"(A) the percentage of the stock of such corporation owned by such person on such day, exceeds

"(B) the percentage of the stock of such corporation owned by such person on December 31, 1982.

"(3) STOCK ACQUIRED BY REASON OF DEATH.—For purposes of paragraph (2), if—

"(A) a person acquires stock in the corporation after December 31, 1982, and

"(B) such stock was acquired by reason of the death of a person who held such stock (or predecessor stock) on such date,

then such stock shall be treated as held on December 31, 1982, by the person described in subparagraph (A). A similar rule shall apply in the case of a series of such acquisitions.

"SEC. 1379. TRANSITIONAL RULES ON ENACTMENT.

"(a) OLD ELECTIONS.—Any election made under section 1372(a) (as in effect before the enactment of the Subchapter S Revision Act of 1982) shall be treated as an election made under section 1362.

"(b) REFERENCES TO PRIOR LAW INCLUDED.—In applying this subchapter to any taxable year beginning after December 31, 1982, any reference in this subchapter to another provision of this subchapter shall, to the extent not inconsistent with the purposes of this subchapter, include a reference to the corresponding provision as in effect before the enactment of the Subchapter S Revision Act of 1982.

"(c) DISTRIBUTIONS OF UNDISTRIBUTED TAXABLE INCOME.—

"(1) IN GENERAL.—If a corporation was an electing small business corporation for the last preenactment year and is an S corporation for the 1st postenactment year, subsections (f) and (d) of section 1375 (as in effect before the enactment of the Subchapter S Revision Act of 1982) shall continue to apply for the period ending on the 15th day of the 3d month following the close of the 1st postenactment year.

"(2) EXTENSION OF 2½-MONTH PERIOD.—For purposes of paragraph (1), the period set forth in such subsection (f) shall be treated as the period which includes the 1st postenactment taxable year and the 2½-month period after the close of such year.

"(d) CARRYFORWARDS.—If a corporation was an electing small business corporation for the last preenactment year and is an S corporation for the 1st postenactment year, any carryforward to the 1st postenactment year which arose in a taxable year for which the corporation was an electing small business corporation shall be treated as arising in the 1st postenactment year.

"(e) PREENACTMENT AND POSTENACTMENT YEARS DEFINED.—For purposes of this subsection—

"(1) LAST PREENACTMENT YEAR.—The term 'last preenactment year' means the last taxable year of a corporation which begins before January 1, 1983.

"(2) 1ST POSTENACTMENT YEAR.—The term '1st postenactment year' means the 1st taxable year of a corporation which begins after December 31, 1982."

SEC. 3. S CORPORATION TREATED LIKE PARTNERSHIP FOR PURPOSES OF CERTAIN PROVISIONS.

(a) DEPLETION IN THE CASE OF OIL AND GAS WELLS (SECTION 613A).—Subsection (c) of section 613A (relating to exemption for independent producers and royalty owners) is amended by adding at the end thereof the following new paragraph:

"(13) SUBCHAPTER S CORPORATIONS.—

"(A) COMPUTATION OF DEPLETION ALLOWANCE AT SHAREHOLDER LEVEL.—In the case of an S corporation, the allowance for depletion with respect to any oil or gas property shall be computed separately by each shareholder.

"(B) ALLOCATION OF BASIS.—The S corporation shall allocate to each shareholder his pro rata share of the adjusted basis of the S corporation in each oil or gas property held by the S corporation. The allocation shall be made as of the later of the date of acquisition of the property by the S corporation, or the first day of the first taxable year of the S corporation to which the Subchapter S Revision Act of 1982 applies. Each shareholder shall separately keep records of his share of the adjusted basis in each oil and gas property of the S corporation, adjust such share of the adjusted basis for any depletion taken on such property, and use such adjusted basis each year in the computation of his cost depletion or in the computation of his gain or loss on the disposition of such property by the S corporation. In the case of any distribution of oil or gas property to its shareholders by the S corporation, the corporation's adjusted basis in the property shall be an amount equal to the sum of the shareholders' adjusted bases in such property, as determined under this subparagraph.

"(C) COORDINATION WITH TRANSFER RULE OF PARAGRAPH (9).—For purposes of paragraph (9)—

"(i) an S corporation shall be treated as a partnership, and the shareholders of the S corporation shall be treated as partners, and

"(ii) an election by a C corporation to become an S corporation shall be treated as a transfer of all its properties effective on the day on which such election first takes effect.

"(D) COORDINATION WITH TRANSFER RULE OF PARAGRAPH (10).—For purposes of paragraphs (9) and (10), if an S corporation becomes a C corporation, each shareholder shall be treated as having transferred to such corporation his pro rata share of all the assets of the S corporation."

(b) WINDFALL PROFIT TAX.—

(1) Paragraph (1) of section 4996(a) (defining producer) is amended by adding at the end thereof the following new subparagraph:

"(C) SUBCHAPTER S CORPORATIONS.—

"(i) IN GENERAL.—If (but for this subparagraph) an S corporation would be treated as a producer of any crude oil—

"(I) such crude oil shall be allocated among the shareholders of such corporation, and

"(II) any shareholder to whom such crude oil is allocated (and not the S corporation) shall be treated as the producer of such crude oil.

"(ii) ALLOCATION.—Except to the extent otherwise provided in regulations, any allocation under clause (i)(I) shall be determined on the basis of the shareholder's pro rata share (as determined under section 1377(a)) of the income of the corporation."

(2) Section 4992 (relating to independent producer oil) is amended by adding at the end thereof the following new subsection:

"(f) S CORPORATION TREATED AS PARTNERSHIP.—For purposes of subsections (d) and (e)—

"(1) an S corporation shall be treated as a partnership, and

"(2) the shareholders of the S corporation shall be treated as partners of such partnership."

(c) USED PROPERTY FOR PURPOSES OF INVESTMENT CREDIT (SECTION 48(c)).—Subparagraph (D) of section 48(c)(2) (relating to partnerships) is amended—

(1) by adding at the end thereof the following new sentence: "A similar rule shall apply in the case of an S corporation and its shareholders.", and

(2) by striking out "PARTNERSHIPS" in the subparagraph heading and inserting in lieu thereof "PARTNERSHIPS AND S CORPORATIONS".

(d) INCOME FROM DISCHARGE OF INDEBTEDNESS (SECTION 108).—Paragraph (6) of section 108(d) (relating to application of section at partner level) is amended to read as follows:

"(6) SUBSECTIONS (a), (b), AND (c) TO BE APPLIED AT PARTNER LEVEL OR S CORPORATION SHAREHOLDER LEVEL.—In the case of a partnership, subsections (a), (b), and (c) shall be applied at the partner level. In the case of an S corporation, subsections (a), (b), and (c) shall be applied at the shareholder level."

(e) ELECTION TO EXPENSE CERTAIN DEPRECIABLE BUSINESS ASSETS (SECTION 179).—Paragraph (8) of section 179(d) (relating to dollar limitation in the case of partnerships) is amended—

(1) by adding at the end thereof the following new sentence: "A similar rule shall apply in the case of an S corporation and its shareholders.", and

(2) by striking out "PARTNERSHIPS" in the paragraph heading and inserting in lieu thereof "PARTNERSHIPS AND S CORPORATIONS".

(f) Amortization of Reforestation Expenditures (Section 194).—Subparagraph (B) of section 194(b)(2) (relating to partnerships) is amended—

(1) by adding at the end thereof the following new sentence: "A similar rule shall apply in the case of an S corporation and its shareholders.", and

(2) by striking out "Partnerships" in the subparagraph heading and inserting in lieu thereof "Partnerships and S corporations".

(g) Treatment of Losses and Unpaid Expenses and Interest in the Case of Transactions Between S Corporations and Certain Related Entities (Section 267(b)).—

(1) Subsection (b) of section 267 (relating to losses, expenses, and interest with respect to transactions between related taxpayers) is amended by adding at the end thereof the following new paragraphs:

"(10) An S corporation and a partnership if the same persons own—

"(A) more than 50 percent in value of the outstanding stock of the S corporation, and

"(B) more than 50 percent of the capital interest, or the profits interest, in the partnership;

"(11) An S corporation and another S corporation if the same persons own more than 50 percent in value of the outstanding stock of each corporation; or

"(12) An S corporation and a C corporation, if the same individual owns more than 50 percent in value of the outstanding stock of each corporation."

(2) Section 267 is amended by adding at the end thereof the following new subsection:

"(f) SPECIAL RULES FOR UNPAID EXPENSES AND INTEREST OF S CORPORATIONS.—

"(1) IN GENERAL.—In the case of any amount paid or incurred by an S corporation, if—

"(A) by reason of the method of accounting of the person to whom the payment is to be made, the amount thereof is not (unless paid) includible in the gross income of such person, and

"(B) at the close of the taxable year of the S corporation for which (but for this paragraph) the amount would be deductible under section 162, 212, or 163, both the S corporation and the person to whom the payment is to be paid are persons specified in one of the paragraphs of subsection (b),

then no deduction shall be allowed in respect of expenses otherwise deductible under section 162 or 212, or of interest otherwise deductible under section 163, before the day as of which the amount thereof is includible in the gross income of the person to whom the payment is made.

"(2) CERTAIN SHAREHOLDERS, ETC., TREATED AS RELATED PERSONS.—For purposes of applying paragraph (1)—

"(A) an S corporation,

"(B) any person who owns, directly or indirectly, 2 percent or more in value of the outstanding stock of such corporation, and

"(C) any person related (within the meaning of subsection (b) of this section or section 707(b)(1)(A)) to a person described in subparagraph (B),

shall be treated as persons specified in a paragraph of subsection (b).

"(3) SUBSECTION (a)(2) NOT TO APPLY.—Subsection (a)(2) shall not apply to any amount paid or incurred by an S corporation."

(3) Subsection (b) of section 267 is amended by striking out "or" at the end of paragraph (8), and by striking out the period at the end of paragraph (9) and inserting in lieu thereof a semicolon.

SEC. 4. TECHNICAL AND CONFORMING AMENDMENTS.

(a) TECHNICAL AMENDMENTS.—

(1) SECTION 44D(d)(9).—Paragraph (9) of section 44D(d) (relating to pass-thru in the case of subchapter S corporations, etc.) is amended to read as follows:

"(9) PASS-THRU IN THE CASE OF ESTATES AND TRUSTS.—Under regulations prescribed by the Secretary, rules similar to the rules of subsection (d) of section 52 shall apply."

(2) SECTION 44E(d)(5).—Paragraph (5) of section 44E(d) (relating to pass-thru in the case of subchapter S corporations, etc.) is amended to read as follows:

"(5) PASS-THRU IN THE CASE OF ESTATES AND TRUSTS.—Under regulations prescribed by the Secretary, rules similar to the rules of subsection (d) of section 52 shall apply."

(3) SECTION 44F.—

(A) Subparagraph (A) of section 44F(f)(2) (relating to pass-thru in the case of subchapter S corporations, etc.) is amended to read as follows:

"(A) PASS-THRU IN THE CASE OF ESTATES AND TRUSTS.—Under regulations prescribed by the Secretary, rules similar to the rules of subsection (d) of section 52 shall apply."

(B) Clause (iv) of section 44F(g)(1)(B) is amended by striking out "an electing small business corporation (within the meaning of section 1371(b))" and inserting in lieu thereof "an S corporation".

(4) SECTION 46(a)(4).—The second sentence of paragraph (4) of section 46(a) (defining liability for tax) is amended by striking out "section 1378 (relating to tax on certain capital gains of subchapter S corporations)," and inserting in lieu thereof "section 1374 (relating to tax on certain capital gains of S corporations),".

(5) SECTION 46(c)(8)(C).—Subparagraph (C) of section 46(c)(8) (relating to special rules for partnerships and subchapter S corporations) is amended by striking out "electing small business corporation (within the meaning of section 1371(b))" and inserting in lieu thereof "S corporation".

(6) SECTION 46(e)(3).—Paragraph (3) of section 46(e) (relating to noncorporate lessors) is amended by striking out "an electing small business corporation (as defined in section 1371)" and inserting in lieu thereof "an S corporation".

(7) SECTION 48(e).—Subsection (e) of section 48 (relating to subchapter S corporations) is hereby repealed.

(8) SECTION 48(k)(5)(D)(i).—The second sentence of clause (i) of section 48(k)(5)(D) (relating to allocation of direct production costs) is amended by striking out "an electing small business corporation (within the meaning of section 1371)" and inserting in lieu thereof "an S corporation".

(9) SECTION 50A(a)(3).—The second sentence of paragraph (3) of section 50A(a) (defining liability for tax) is amended by striking out "section 1378 (relating to tax on certain capital gains of subchapter S corporations)," and inserting in lieu thereof "section 1374 (relating to tax on certain capital gains of S corporations),".

(10) SECTION 50B(d).—Subsection (d) of section 50B (relating to subchapter S corporations) is hereby repealed.

(11) SECTION 52(d).—Section 52 is amended by striking out subsection (d) and by redesignating subsections (e) and (f) as subsections (d) and (e), respectively.

(12) SECTION 53(a).—The second sentence of subsection (a) of section 53 (relating to limitation based on amount of tax) is amended by striking out "section 1378 (relating to tax on certain capital gains of subchapter S corporations)," and inserting in lieu thereof

"section 1374 (relating to tax on certain capital gains of S corporations),".

(13) SECTION 57(a).—The next to the last sentence of section 57(a) (defining items of tax preference) is amended by striking out "an electing small business corporation (as defined in section 1371(b)) and".

(14) SECTION 58(d).—Subsection (d) of section 58 (relating to electing small business corporations and their shareholders) is amended to read as follows:

"(d) CERTAIN CAPITAL GAINS OF S CORPORATIONS.—If for a taxable year of an S corporation a tax is imposed on the income of such corporation under section 1374, such corporation shall be subject to the tax imposed by section 56, but computed only with reference to the item of tax preference set forth in section 57(a)(9)(B) to the extent attributable to gains subject to the tax imposed by section 1374."

(15) SECTION 62(9).—Paragraph (9) of section 62 (relating to pension, etc., plans of an electing small business corporation) is hereby repealed.

(16) SECTION 163(d)(4).—Paragraph (4) of section 163(d) (relating to limitation on interest on investment indebtedness) is amended by striking out subparagraphs (B) and (C) and redesignating subparagraph (D) as subparagraph (B).

(17) SECTION 168(f)(8)(B).—Clause (i) of section 168(f)(8)(B) (relating to special rules for leases) is amended by striking out "an electing small business corporation (within the meaning of section 1371(b))" and inserting in lieu thereof "an S corporation".

(18) SECTION 170(e).—

(A) Subparagraph (A) of section 170(e)(3) (defining qualified contributions) is amended by striking out "an electing small business corporation within the meaning of section 1371(b))" and inserting in lieu thereof "an S corporation)".

(B) Clause (i) of section 170(e)(4)(D) is amended to read as follows:

"(i) an S corporation,".

(19) SECTION 172(f).—Subsection (f) of section 172 (relating to disallowance of net operating loss of electing small business corporations) is hereby repealed.

(20) SECTION 183(a).—Subsection (a) of section 183 (relating to activities not engaged in for profit) is amended by striking out "an electing small business corporation (as defined in section 1371(b))" and inserting in lieu thereof "an S corporation".

(21) SECTION 189(a).—The second sentence of subsection (a) of section 189 (relating to amortization

of real property, construction period, and taxes) is amended by striking out "an electing small business corporation (as defined in section 1371(b))," and inserting in lieu thereof "an S corporation,".

(22) SECTION 280(a).—The second sentence of subsection (a) of section 280 (relating to certain expenditures incurred in production of films, books, records, or similar property) is amended by striking out "an electing small business corporation (as defined in section 1371(b))," and inserting in lieu thereof "an S corporation,".

(23) SECTION 280A.—

(A) Subsection (a) of section 280A (relating to disallowance of certain expenses in connection with business use of home, rental of vacation homes, etc.) is amended by striking out "an electing small business corporation," and inserting in lieu thereof "an S corporation,".

(B) Paragraph (1) of section 280A(e) is amended by striking out "an electing small business corporation" and inserting in lieu thereof "an S corporation".

(C) Paragraph (2) of section 280A(f) is amended to read as follows:

"(2) PERSONAL USE BY SHAREHOLDERS OF S CORPORATION.—In the case of an S corporation, subparagraphs (A) and (B) of subsection (d)(2) shall be applied by substituting 'any shareholder of the S corporation' for 'the taxpayer' each place it appears."

(24) SECTION 401.—Clause (ii) of section 401(j)(5)(C) is amended by striking out "the electing small business corporation" and inserting in lieu thereof "the S corporation".

(25) SECTION 447(c)(1).—Paragraph (1) of section 447(c) (relating to exception for small business and family corporations) is amended to read as follows:

"(1) an S corporation,".

(26) SECTION 464(c)(1).—Paragraph (1) of section 464(c) (defining farming syndicate) is amended by striking out "an electing small business corporation (as defined in section 1371(b))" each place it appears and inserting in lieu thereof "an S corporation".

(27) SECTION 465.—

(A) Paragraph (1) of section 465(a) (relating to deductions limited to amount at risk) is amended by adding "and" at the end of subparagraph (A), by striking out subparagraph (B), and by redesignating subparagraph (C) as subparagraph (B).

(B) Paragraph (3) of section 465(a) is amended—

(i) by striking out "paragraph (1)(C)" and inserting in lieu thereof "paragraph (1)(B)", and

(ii) by striking out "PARAGRAPH (1)(C)" in the paragraph heading and inserting in lieu thereof "PARAGRAPH (1)(B)".

(C) The last sentence of paragraph (2) of section 465(c) is amended—

(i) by striking out "an electing small business corporation" the first place it appears and inserting in lieu thereof "an S corporation", and

(ii) by striking out "an electing small business corporation" the second place it appears and inserting in lieu thereof "the S corporation".

(D) Clause (ii) of section 465(c)(3)(B) is amended by striking out "electing small business corporation (as defined in section 1371(b))" and inserting in lieu thereof "an S corporation".

(E) Subparagraph (A) of section 465(c)(4) is amended by striking out "subsection (a)(1)(C)" and inserting in lieu thereof "subsection (a)(1)(B)".

(28) SECTION 992(d)(7).—Paragraph (7) of section 992(d) (relating to corporations not eligible to be a DISC) is amended to read as follows:

"(7) an S corporation."

(29) SECTION 1016(a)(18).—Paragraph (18) of section 1016(a) (relating to adjustments to basis) is amended to read as follows:

"(18) to the extent provided in section 1367 in the case of stock of, and indebtedness owed to, shareholders of an S corporation;".

(30) SECTION 1101(a)(3)(D).—Subparagraph (D) of section 1101(a)(3) (relating to non-pro rata distributions from certain closely held corporations) is amended by striking out "section 1371(a)(1)" and inserting in lieu thereof "section 1361(b)(1)(A)".

(31) SECTION 1212(a).—Subsection (a) of section 1212 (relating to capital loss carrybacks and carryovers of corporations) is amended by striking out paragraph (3) and by redesignating paragraph (4) as paragraph (3).

(32) SECTION 1251(b)(2)(B).—

(A) Subparagraph (B) of section 1251(b)(2) (relating to excess deductions account) is amended—

(i) by striking out "an electing small business corporation (as defined in section 1371(b))," and inserting in lieu thereof "an S corporation,", and

(ii) by striking out "electing small business corporation" each place it appears in the second and third sentences and inserting in lieu thereof "S corporation".

(B) Subparagraph (D) of section 1251(d)(2) is amended by striking out "an electing small business corporation" and inserting in lieu thereof "an S corporation".

(33) SECTION 1254(b)(2).—Paragraph (2) of section 1254(b) (relating to special rules for gain from dispositions of interest in oil, gas, or geothermal property) is amended by striking out "an electing small business corporation (as defined in section 1371(b))," and inserting in lieu thereof "an S corporation,".

(34) SECTION 1256(e)(3)(B).—Subparagraph (B) of section 1256(e)(3) (defining syndicate) is amended by striking out "an electing small business corporation

within the meaning of section 1371(b)" and inserting in lieu thereof "an S corporation".

(35) SECTION 6037.—

(A) Section 6037 (relating to return of electing small business corporation) is amended—

(i) by striking out "Every electing small business corporation (as defined in section 1371(b))" and inserting in lieu thereof "Every S corporation",

(ii) by striking out "and such other information" and inserting in lieu thereof "each shareholder's pro rata share of each item of the corporation for the taxable year, and such other information", and

(iii) by striking out "**ELECTING SMALL BUSINESS CORPORATION**" in the section heading and inserting in lieu thereof "**S CORPORATION**".

(B) The table of sections for subpart A of part III of subchapter A of chapter 61 is amended by striking out "electing small business corporation" in the item relating to section 6037 and inserting in lieu thereof "S corporation".

(36) SECTION 6042(b)(2).—Paragraph (2) of section 6042(b) (defining dividend) is amended to read as follows:

"(2) EXCEPTIONS.—For purposes of this section, to the extent provided in regulations prescribed by the Secretary, the term 'dividend' does not include any distribution or payment—

"(A) by a foreign corporation, or

"(B) to a foreign corporation, a nonresident alien, or a partnership not engaged in a trade or business in the United States and composed in whole or in part of nonresident aliens."

(37) SECTION 6362(f)(7).—Paragraph (7) of section 6362(f) (relating to partnerships, trusts, subchapter S corporations, and other conduit entities) is amended—

(A) by striking out "electing small business corporations (within the meaning of section 1371(a))" in subparagraph (D) and inserting in lieu thereof "S corporations", and

(B) by striking out "SUBCHAPTER S CORPORATIONS," in the paragraph heading.

(b) CLERICAL AMENDMENT.—The table of subchapters for chapter 1 is amended by striking out the item relating to subchapter S and inserting in lieu thereof the following:

"SUBCHAPTER S. Tax treatment of S corporations and their shareholders."

SEC. 5. EFFECTIVE DATES.

(a) IN GENERAL.—Except as provided in subsection (b), the amendments made by this Act shall apply to taxable years beginning after December 31, 1982.

(b) TRANSITIONAL RULE.—In the case of any plan in existence on the date of enactment of this Act, for taxable years or plan years (whichever is appropriate) beginning before January 1, 1985—

(1) section 1372 of the Internal Revenue Code of 1954 (as added by this Act) shall not apply, but

(2) sections 1379 and 62(9) of such Code (as in effect before the date of the enactment of this Act) shall apply.

Chairman **Stark**. I would also indicate that the record remain open for sufficient time for other members of the subcommittee to direct written questions to the witnesses and to give the witnesses time, to respond so that both the questions of other members and a response can be made part of the record.

As we have done in the past we will run the light system, asking people to summarize their testimony.

I would hope that their summary can address those problems where there are differing opinions; namely, the treatment of regular corporations electing subchapter S and the classes of stock and the foreign income limitations. Any other items where people find that they have a disagreement with parts of the legislation, if you can direct your testimony that way, it will be helpful.

Our first witness this morning is the Honorable David Glickman, Deputy Assistant Secretary of the Treasury for Tax Legislation.

You may proceed, David, in any way you see fit.

STATEMENT OF DAVID GLICKMAN, DEPUTY ASSISTANT SECRETARY FOR TAX LEGISLATION, DEPARTMENT OF THE TREASURY

Mr. **Glickman**. I am pleased to appear before you today to express the views of the Treasury Department on H.R. 6055, the Subchapter S Revision Tax Act of 1982. I will attempt to paraphrase my statement.

Chairman **Stark**. I think in the back of the room your audience is straining.

Mr. **Glickman**. My statement is long, and thus I will try to paraphrase it and touch on the most critical issues with respect to the foreign issue which you mentioned, Mr. Chairman. Our testimony does not have anything on that, but with your permission I will submit something for the record subsequently.

Chairman **Stark**. Without objection.

[The information follows:]

Supplemental Statement of David G. Glickman

The Treasury Department has reviewed the foreign income limitation of current law, which is retained in the present draft of the Subchapter S Revision Act of 1982. Under proposed section 1362(d)(4), a Subchapter S election is terminated if the corporation derives more than 80 percent of its gross receipts for any taxable year from foreign sources. We would support elimination of this restriction, as we see no reason to limit the international business transactions of Subchapter S corporations. Moreover, the current rules can lead to inadvertent termination of an election and can sometimes be avoided through manipulation of the source rules.

Mr. **Glickman**. The bill, which has also been introduced in the Senate, reflects the comments of the staffs of the Senate Finance Committee, House Ways and Means Committee, Joint Committee on Taxation, and the Treasury staff, as well as the Tax Section of the American Bar Association, the Federal Tax Division of the American Institute of Certified Public Accountants and various other professional groups. We believe that this collegial approach, with broad-based participation by congressional and Treasury staffs and the private sector, is a fruitful way to develop technical tax legislation of this type. A similar process culminated in the Installment Sales Revision Act of 1980, and we are hopeful that we can be equally successful in the subchapter S area.

Treasury generally supports the changes made by the subchapter S bill. Subchapter S has been criticized as a complex set of provisions posing numerous traps for the unwary. We believe that the bill represents a substantial step forward toward simplifying and rationalizing the subchapter S area.

Of course, further technical improvements in the bill can undoubtedly be made. We hope these potential improvements will be identified through the hearing process and additional efforts of the staffs. Also, the sponsors have requested further comment on several issues, and we will address these in my testimony.

Since the bill contains a number of technical provisions, I will not discuss each one. However, I would just like to tick off a few of the most important improvements that I think the bill would accomplish.

First, the bill adopts rules for subchapter S corporations that are similar in several respects to the current tax rules applicable to partnerships. For example, it adopts rules providing for the passthrough of specific items to shareholders.

The partial elimination of the earnings and profits account at the subchapter S corporate level will have a great simplification effect. The bill provides for the allocation of income on a per-share, per-day basis.

Thus, on stock transfers, the year's income will be allocated between buyer and seller rather than all being taxed to the buyer. This will help to prevent tax avoidance and potential gaming of the system.

A loss carryover rule provides in essence that losses which can't be used by a shareholder because he has insufficient basis for his stock will be allowed in subsequent years when sufficient basis is restored.

The bill would allow a subchapter S corporation to have nonvoting common stock. This is one of the class of stock issues. There are other one class of stock issues that I will discuss later.

The bill eliminates the passive income limitation for certain subchapter S corporations. This test, which has been a litigation-producing and controversial test will be eliminated for subchapter S corporations that have no accumulated earnings and profits at the time of the election.

Also, the bill will eliminate the retroactive termination rules to prevent people from having the ability to make the decision after the fact whether they want to have a subchapter S corporation.

The commissioner would be given authority to waive inadvertent terminations. There are also a number of other provisions. One which I also consider of great importance is a provision concerning entity level audits, which is a much needed provision very similar to the one in H.R. 6300.

I believe these points illustrate that the bill will make many desirable changes, both eliminating the traps for the unwary and curbing certain tax avoidance opportunities. We look forward to working with the committees on it.

However, there are two major areas in particular which the sponsors of the bill have requested further consideration: the so-called "C to S" issues and the "second class of stock issue."

I would like to take the remainder of my time and talk about these two issues because I think that they are probably the two most critical issues in determining whether this bill is going to move forward and in what form.

Under present law, Mr. Chairman, when the shareholder of a corporation that had been operating as a subchapter C corporation elects to be taxed under subchapter S, the election serves to lift the double tax. In other words, the election would result in a single tax at the individual level. The lifting of this burden, in essence, frees from the corporate tax the future income of the corporation and makes the corporation in that sense resemble a partnership.

As we get closer and closer in this bill to making a subchapter S corporation resemble a partnership, we have to start looking at how you would normally go from a subchapter C corporation to a partnership—that is, a liquidation—and how those rules should interface with the rules for going from C to S—that is, a subchapter S election. This is where we really have the problem.

Now, although the subchapter S election and liquidation are quite similar, the tax treatment is quite different. If you go from subchapter C to subchapter S, there is no tax generated on that tranformation. However, there are stringent limitations, one of the most significant being the 20 percent passive investment income rule, which prevent corporations that are presently in the active conduct of a trade or business from selling that business, investing all of the proceeds in passive investments, and flowing the passive income through with only a single tax at the shareholder level.

If a true liquidation approach were adopted or if you were to liquidate and go into partnership solution, there would be a tax generated. For example, if the liquidation were under section 331 there would in general be a capital gain tax on the difference between the shareholder's basis in the stock and the fair market value of the assets coming out.

Now, the shareholder in that situation would get a step-up in basis, but the tax would have to be paid in that type of situation. So what we are comparing here, at least in a section 331 liquidation, is a tax with a basis step-up, as compared in a subchapter S context with no tax with a carryover basis, and the question is whether it is appropriate to leave that type of distinction in effect.

Over the next several pages of my statement I get into an analysis of this distinction, but I think for the sake of brevity it would be worthwhile to say that to a large degree it comes down to the distinction between corporations that have accumulated earnings and profits and those corporations that do not on the day the subchapter S election is made.

I think that when you draw out that distinction, the issue becomes a lot clearer. For example, if you have a corporation that has no earnings and profits, there is a possibility that even where there is a liquidation followed by the formation of a partnership, this can be done tax free under section 333 with a carryover basis, and thus it becomes very similar to the subchapter S situation. However, if the corporation has earnings and profits, the earnings and profits will be taxable, but in the section 333 mode at ordinary income rates.

Even in the context of the liquidation under 331 of a regular corporation that then goes into partnership solution, you come down to the question of the earnings and profits because even in that context those earnings and profits would be taxed, although at capital gains rates.

So, it seems to us that the difference in tax treatment between a corporation that liquidates and one that elects subchapter S is most important for the type of corporation that has the earnings and profits.

Now, the bill addresses this problem by simply forbidding a corporation from electing subchapter S if it has accumulated earnings and profits and it does not meet the passive investment income test that is presently in the law.

So, the corporation could not sell its business, take all of the proceeds and invest them in passive investments while it has earnings and profits. It would, in essence, have to distribute those earnings and profits, in which case the shareholder would have to pay ordinary income tax at that point in time. In providing this result, the bill really preserves the current law with respect to those corporations that have earnings and profits today.

Now, the issue again really comes down to what cost should be imposed upon the election of the subchapter S by the corporation with accumulated earnings and profits. It seems to us that there are three possible alternatives:

We can adopt the pure liquidation approach, that is, treat moving from C to S in basically the same way for tax purposes as moving from corporate solution to partnership solution, with all of the ramifications.

We could adopt the solution now in the bill which provides that there will be no tax upon electing subchapter S but, that the corporation, if it does have earnings and profits, will still be subject to the present passive investment income rules.

Or, we could adopt a modified liquidation tax upon the election of subchapter S.

From a purely intellectual standpoint, it seems to us that when we analyze going from C to S and compare it to going from a corporation to a partnership, probably the liquidation approach is the most correct approach. However, election under subchapter S is not exactly the same as a liquidation and, in addition to that, the imposition of the liquidation tax we understand—and possibly rightly so—would be perceived as an unacceptable type of result in that situation.

Now, with respect to the approach in the bill, we think this approach has advantages and disadvantages. To some degree they are sort of opposite sides of the same coin. For example, we would hope that most corporations would eliminate their accumulated earnings and profits so that the passive investment income rules would not apply. We hope whatever we come up with would provide a stimulus for taxpayers to move into that type of situation as opposed to moving into a situation where they would still be subject to the passive income rules that are in place right now, which have given us all so much trouble.

So, as a possible benefit you could say that there is an incentive here for the corporation to distribute out its earnings and profits, especially where they are not great, in order to get out from under the passive income test and its traps for the unwary.

The opposite side of the coin is that the accumulated earnings and profits are required to be distributed and taxed at ordinary rates in order to get out from under the passive income test. The problem immediately arises as to how many regular corporations are going to take that approach and pay ordinary income tax on those dividends.

Obviously if the earnings and profits are not great, they may go through it, but what about the corporations that have been accumulating earnings and profits for many years? They may stay subject to the passive income test of current law with all of its difficulties.

In addition to that, I guess it is fair to say that it is difficult to see a conceptual difference between the case where you sell all of your active assets and invest the proceeds in passive investments and the case where you continue to operate a going trade or business. Why should the going business be permitted to achieve passthrough taxation without payment of tax while the corporation with passive assets cannot.

Intellectually, I can't see why there ought to be a distinction there, but at the same time, on balance, there does seem to be a problem in permitting corporations with accumulated E. & P. to elect subchapter C without payment of a tax. To some degree we are using the passive investment income test to avoid that problem, or at least to keep that problem from getting worse than it is under current law.

Now, there has been a great deal of discussion about the third alternative, some sort of modified liquidation tax. As I say in my statement, Mr. Chairman, this approach does have some promise to it, it seems to us, although there are a number of questions that have to be answered as we move through it.

The first one again is, is it justified to permit a corporation to go into a pure passthrough mode at the price of a capital gains tax on earnings and profits.

I discussed the section 333 analogy, where the tax is only on earnings and profits, at least in many cases. That, again, is taxing earnings and profits at ordinary income rates where we would be talking about a capital gains tax here.

The better argument is the argument by analogy to section 331. One would argue that no tax on the appreciated property with a carryover basis is not a lot different than the tax on the appreciation with the step-up in basis. What is left is the accumulated earnings and profits, which in the section 331 context would be taxed at capital gains rates.

But that is not a pure answer, either, because some of the appreciated property might be land and intangibles that you would not be able to write off over a period of time, as you would tangible personal property.

The next question would be when you would pay the tax. There has been some discussion that this really is a liquidity type of issue and that there ought to be some stretch-out of the time for paying the tax, perhaps several years. This gets us into the question of whether you ought to be able to defer the tax without interest or whether you ought to pay some interest on the deferred tax.

One of the severe problems in this area is the bailout potential. The problem is to prevent people from going from C to S, distributing out earnings and profits at capital gains rates and then going back to C and building earnings and profits up and distributing them out again.

This is a potential bailout of earnings and profits, and any bill we came up with would have to do something to assure that that type of abuse was prevented.

Finally, I guess the last real substantial problem is that if we adopted the modified liquidation approach, should we leave out there another way to go. In other words, should we leave current law where people are allowed to still go from C to S without paying any liquidation tax at all, but still would be subject to the rules that are presently out there under subchapter S, for example, the passive investment income test.

Many corporations not planning on selling their active assets and investing in passive assets—and therefore not running up against the passive investment income test—may be comfortable with the present law rule which doesn't impose any tax on electing subchapter S. The problem is keeping two tracks in place at the same time. We would have two separate sets of laws that from a simplification standpoint gives us some problem.

Another problem I guess we would have to consider is all of the subchapter S's out there right now, or present subchapter C corporations out there now that have been planning perhaps over the years with present law in mind.

Perhaps if we did adopt a two-track approach we ought to think of some type of sunset rule so that at some point in time the law is actually simplified to the extent that we hoped it would be.

Although these are difficult issues, Mr. Chairman, this approach I think reduces the tax burden of eliminating the accumulated earnings and profit account, such that more corporations undoubtedly would incur the tax to go under simpler rules. We will be happy to work with the staffs of the committees to see if we can work this alternative out in a way that avoids the problem.

The second issue which I would like to discuss with you today concerns the second class of stock problem. I mentioned it earlier, saying that with respect to the one class of stock requirement the bill would provide that a nonvoting common stock is not going to be deemed a second class of stock.

Under current law, a subchapter S corporation may have only one class of stock. Now, the significance of this is that if you do have a second class of stock, subchapter S cannot be elected, or if you are in subchapter S at that point in time, the subchapter S election is terminated, retroactive to the time that the second class of stock came into existence. This is a very harsh rule.

Now, for a number of years the Service litigated the second class of stock issue, not successfully. Finally, a number of years ago, the Service said that they were not going to litigate cases similar to the ones they had lost anymore, and for the last 8 or 9 years they have not been litigating many of these second class of stock cases, but the issue is still out there.

Now, the bill does not address this issue, but this was one of the issues which Chairman Rostenkowski and Mr. Conable, as we said, specifically asked for comment on. We have analyzed the issue and I would like to give you some of our thoughts on it.

The reason for the single class of stock requirement is that the existence of multiple class of stock would make it too difficult to allocate subchapter S income and losses among corporate stockholders. We believe this position is sound and that it should remain in the law.

As soon as you say that, the question comes up: Can you get around that rule by, instead of issuing a second class of stock, issuing a debt instrument of some sort which is purported to be debt but is tantamount to a second class of stock. This means that we are forced to examine the debt—equity issue, which I think is the one that is giving most of us the major problems.

There are two particular abuses that we are concerned about. First, we are concerned about instruments being held by shareholders who are not eligible to be shareholders of subchapter S corporation; for example, foreigners. Since they couldn't own the stock directly you might set up a class of debt and let them own the debt.

The second issue concerns the allocation of income and losses. If you set up a class of debt which is really equity, you possibly can structure a transaction in which losses are allocated to one party, whereas income is allocated to another. Subchapter S does not envision that type of arrangement, even though economically this may be the deal that was struck.

So, these are the two basic problems that I think we have in the area.

In the text I have given some examples, Mr. Chairman, of how these problems arise and the types of solutions we think that we ought to be looking at. But I will again for brevity's sake skip the examples.

Having set forth what our general concerns are, I think we ought to be more specific in our discussion of a sensible approach for when we should reclassify various types of straight debt and hybrid debt instruments as a second class of stock, thus disqualifying the subchapter S election.

The issue that we are dealing with is a debt-equity issue. It gets into the question of whether something is debt or equity for tax purposes, which we think should first be approached by examining whether it is treated as debt or equity under whatever regulations are adopted under section 385 or under the current law rules that are out there.

If under current law or the 385 regulations an instrument would be classified as debt, whether it is hybrid or whether it is straight debt, we think it should be recognized as debt for subchapter S purposes. Thus, the only time we get into the second class of stock issue is where the debt would be classified under the 385 regulations or the case law as equity, and in that situation we start asking ourselves what effect should that have on subchapter S.

Now, this is interesting because we must look at several basic types of situations:

One situation is where we have purported debt that is not issued proportionately. Generally the type of debt that is not issued proportionately will be recognized as debt under the debt-equity rules so that really shouldn't be the one that gives us the problem.

The situations that the debt-equity rules look at more than any others are debt issued proportionately, either directly proportionately or constructively proportionately. It is interesting because under the normal debt-equity rules, where you have a straight subchapter C corporation, proportionate debt is the situation you are most concerned about. In the subchapter S context, this situation is the one you are probably least concerned about because in that situation, if the debt is issued absolutely proportionately, the shareholders who must already be eligible persons to be shareholders are the ones that own the debt, which takes care of the first problem; and the allocations are not affected by treating the debt as a second class of stock, which takes care of our second problem.

So in the situation of proportionate debt, we simply do not think, if it is straight debt, that it ought to give us a problem.

There are problems, however, where the straight debt is issued constructively proportionately, for example, where the son owns all of the stock and the father owns all of the debt. This gets you into the situation where the debt holder may not be dealing at arm's length with the corporation, and either the interest rate may be too high or the interest rate may be too low.

Again, remember we are talking only about that debt that under the normal debt-equity rules would be deemed equity for tax purposes. There are a number of these types of situations out there, Mr. Chairman. We have reviewed them and it seems to us that if you have straight debt, as a practical matter, that debt should never be deemed a second class of stock that disqualifies the Subchapter S election.

However, for the types of problems I just mentioned to you, it seems to me that more tailored rules ought to be directed toward them to make sure that tax avoidance problems are eliminated, and the bill has done this in many situations. There are other problems that we have found which the bill has not yet covered, but again we think rules ought to be directed to prevent these particular types of problems without terminating the subchapter S election, where we have the straight debt situation.

With hybrid debt, our problems are different. The hybrid debt is one where either there is a conversion privilege or the payments are based for example upon the amount of income earned by the corporation. It truly smacks of an equity type of participation. I think that our analysis indicates that this is the type of debt which causes the greatest problem, and as a general proposition, from my experience, I do not believe that the small businesses that go into subchapter S generally use this type of sophisticated planning device, that is hybrid indebtedness.

Thus we are not setting up a trap for the unwary, which is something we are trying our best to avoid. We do not want to put more rules out there that will do the same thing which the present law does. So I think that what you generally will find when you are talking about the hybrids are the more sophisticated companies with the more sophisticated representatives, who will know what the problem is and they are the ones, it seems to me, that will either be able to solve the problem in some other fashion, or will be able to advise their clients what the problems are that they are facing by using the hybrid debt.

So I guess, Mr. Chairman, Treasury feels that it is appropriate, if hybrid debt is issued, and it is found to be equity again under the normal debt-equity rules, that the hybrid debt should be classified as a second class of stock, thus disqualifying the subchapter S election and we, again, do not see that this would create a trap for the unwarry as some of the others would.

There are a number of other problems which we have been considering. Those are discussed in my testimony. One of them involves the conversion of operating income to investment income. This can have an effect under the laws limiting the deductibility of investment interest. We think that something ought to be done in that area.

Also, there is a possible timing differential created where deductions are taken at the corporate level because the corporation is on the accrual basis, but the shareholder doesn't include the income because it is a cash basis taxpayer. Thus we get a mismatching. This type of problem is covered in the bill right now, we think appropriately so.

I do want to state, Mr. Chairman, that with respect even to the hybrid debt, although our initial reaction is that it ought to disqualify the subchapter S election if it is treated as equity, this does not mean that we are not at least willing to talk and find out if there are other ways to solve the problems we are concerned about without taking that type of approach. We simply are having difficulty seeing other solutions at this time.

Finally there are a number of other issues covered in the bill which we think can be worked out subsequently. I have already said with respect to the foreign issue which you mentioned that we will submit an additional statement on it.

There are also issues concerning the proper treatment of warrants issued by a subchapter S corporation. There are also issues concerning the pension area and its interfacing with the new rules. As you know we have testified on the pension issue last Thursday.

Finally, there is an issue concerning a debt instrument that was equity when the corporation was subchapter C. If that corporation then elects subchapter S, what is the effect if that debt instrument—which was reclassified as equity in the C context—then is reclassified as debt in the S context. That is a complex issue that has given us much food for thought, and that has to be reviewed.

I will now be pleased to answer any questions you might have.

[The prepared statement follows:]

STATEMENT OF DAVID G. GLICKMAN, DEPUTY ASSISTANT SECRETARY (TAX POLICY), DEPARTMENT OF THE TREASURY

Mr. Chairman and Members of this Subcommittee:

I am pleased to appear before you to express the views of the Treasury Department on H.R. 6055, the Subchapter S Revision Tax Act of 1982.

This bill, which has also been introduced in the Senate by Senators Dole and Long as S. 2350, reflects the comments of the staffs of the Senate Finance Committee, House Ways and Means Committee, Joint Committee on Taxation and the Treasury staff as well as the tax section of the American Bar Association, the Federal tax division of the American Institute of Certified Public Accountants and various other professional groups and individuals. We believe that this collegial process, with broad-based participation by Congressional and Treasury staffs and the private sector, is a fruitful way to develop technical tax legislation of this type. A similar process culminated in the Installment Sales Revision Act of 1980 and we are hopeful that we can be equally successful in the Subchapter S area.

Treasury generally supports the changes made by this Subchapter S bill. Subchapter S has been criticized as a complex set of provisions posing numerous "traps for the unwary" and we believe that the bill represents a substantial step toward simplifying and rationalizing the Subchapter S area. Of course, further technical improvements in the bill can undoubtedly be made. We hope that these potential improvements will be identified both through the hearing process and through additional efforts of our staffs. Also, the sponsors of the bill have requested further comment on several issues and we will address these issues later in our testimony.

Since the bill contains a large number of technical provisions, we will not discuss each one. However, we would like to set forth the most significant of the improvements made by the bill.

Partnership-like treatment. In several significant areas, the bill adopts rules for Subchapter S corporations which are similar to the current tax rules applicable to partnerships.

- Pass through treatment. Under current law, except for long-term capital gains, the character of income at the corporate level of a Subchapter S corporation is not passed through to its shareholders. Under the bill, the character of the corporate level items would pass through to shareholders in a manner analogous to partnership tax treatment. For example, capital gains and losses would pass through to shareholders as capital gains and losses. Section 1231 gains and losses would pass through without prior aggregation at the corporate level. Charitable contributions would pass through to the shareholders and would thus be subject to the individual's limits on deductibility. Tax exempt income would pass through as such and subsequent distribution of this income would generally not result in taxation. Foreign taxes paid by the corporation would pass through as such to the shareholders who would, subject to applicable limitations, claim them as credits or deductions. However, neither the Subchapter S corporation nor its shareholders would be eligible for the deemed-paid credit of section 902 for foreign taxes paid by foreign corporations in which the Subchapter S corporation owned stock.

- Partial elimination of earnings and profits. Under current law, a Subchapter S corporation maintains current and accumulated earnings and profits accounts in the same manner as a Subchapter C corporation. Distributions out of earnings and profits are taxed as dividends to shareholders except as special rules relating to distributions of "previously taxed income" and certain "undistributed taxable income" apply to prevent double taxation. The result is a complex statutory scheme, requiring careful attention to avoid inadvertent double taxation. Under the bill, Subchapter S corporations formed after the bill's effective date and other Subchapter S corporations without any accumulated earnings and profits would no longer have earnings and profits accounts so long as they remained Subchapter S corporations. This greatly simplifies the distribution rules for these Subchapter S corporations.

- Allocation of income on stock transfer. Under current law, a Subchapter S corporation's undistributed taxable income is includible in the income of the shareholders owning stock on the last day of the corporation's taxable year. This enables current shareholders to shift income to investors buying stock of a Subchapter S corporation late in the corporation's taxable year. Under the bill, the corporation's income would be taxed to its shareholders on a daily prorated basis (the way losses are currently allocated) unless the corporation closes its books on the date a shareholder terminates his interest in the corporation. This change provides a more realistic allocation of a Subchapter S corporation's income in a taxable year when there is a stock transfer.

- Loss carryover allowed. Under current law, a shareholder can deduct his pro rata share of a Subchapter S corporation's losses to the extent of his basis in the corporation's stock and debt. If the shareholder's allocable share of a corporation's loss exceeds the sum of these two basis amounts, the excess is not allowable as a carryover, even if sufficient basis is restored in a later year. Under the bill, such excess would be allowable as a carryover and could thus be deducted by the shareholder in the year sufficient basis is restored. This rule is analogous to the partnership tax rule.

Nonvoting common stock allowed. A Subchapter S corporation is permitted to have only one class of stock. Under the bill, a corporation would not be treated as having more than one class of stock solely by reason of differences in voting rights among the shares of common stock. Since differences in voting rights do not contravene the policies underlying the single class of stock requirement -- and since voting trusts are already permitted -- this is a sensible modification.

Partial elimination of passive income limitation. The bill eliminates the 20 percent passive income limitation for Subchapter S corporations with no accumulated earnings and profits. This eliminates a source of inadvertent terminations of Subchapter S elections -- and a source of wearying litigation -- for a significant class of Subchapter S corporations. The retention of the passive income limitation for corporations with accumulated earnings and profits will be discussed later in this statement.

Retroactive terminations eliminated. Under current law, a mid-year termination of a Subchapter S election is retroactive to the beginning of the taxable year. This enables shareholders of a Subchapter S corporation to decide after the fact whether it would be better to be taxable under Subchapter S or Subchapter C for the year, an unjustifiable opportunity for tax planning. The bill would eliminate this unwarranted opportunity by making a termination effective as of the date of the event causing the termination (thus splitting the taxable year into a short "S" year and a short "C" year).

IRS authority to waive inadvertent terminations. The bill gives the Internal Revenue Service the authority to waive an inadvertent termination of a Subchapter S election, subject to such adjustments as the Service may require. This would allow the Service to mitigate the sometimes unjustifiably harsh consequences of an inadvertent technical termination.

"Blackmail power" eliminated. Under current law, a new shareholder of an existing Subchapter S corporation can cause termination of the election by affirmatively refusing to consent, a power sometimes colorfully referred to as a "blackmail power." The bill would eliminate this "blackmail power" by making a new shareholder bound by a pre-existing Subchapter S election.

Limitation on fiscal year selection. Under current law, there are no limitations on the selection of a fiscal year by a Subchapter S corporation. This allows shareholders of a Subchapter S corporation to achieve substantial deferral of income by artful selection of the corporation's taxable year (*e.g.*, an 11-month deferral for calendar year shareholders by selection of a January 31 fiscal year for the corporation). The bill eliminates this unwarranted planning opportunity by requiring a Subchapter S corporation to use a calendar taxable year unless it can demonstrate to the Service's satisfaction a business purpose for a different taxable year (subject to a generous "grandfather" rule for existing Subchapter S corporations).

Entity-level audit. Finally, the bill provides an entity-level audit provision for Subchapter S corporations. Under this provision, the tax treatment of items of Subchapter S income, loss, deductions and credits would generally be determined at the corporate level, with shareholders receiving notice and opportunity to participate in any administrative or judicial proceeding. This much-needed provision is similar to the one in H.R. 6300 (the Tax Compliance Act of 1982).

As these changes illustrate, the bill makes many desirable changes in the Subchapter S provisions. It simplifies the Subchapter S area, eliminates "traps for the unwary" and curbs tax avoidance opportunities. We look forward to working with the committee staffs as technical issues emerge from the public comments and further staff study.

There are two major areas in particular for which the sponsors of the bill request further consideration: the so-called "C to S" problem involving the election of Subchapter S by an active business corporation that has been operating under Subchapter C and the "second class of stock" problem involving the question of when purported debt should be considered a second class of stock, thus disqualifying a Subchapter S election.

The "C to S" Problem

Under present law, when the shareholders of a corporation which has been operating under the Subchapter C regime elect to be taxed under Subchapter S, the election serves to lift the double tax (i.e., the corporate income tax plus the dividend or capital gain tax on the shareholder upon distribution) from the future income of the corporation and to replace it with a single tax, at the individual shareholder's rates. In lifting the burden of the corporate tax from the future income of the corporation, the Subchapter S election resembles a liquidation of the corporation. As the Subchapter S provisions are changed to further resemble the partnership tax provisions (e.g., by passing through to the shareholders the character of corporate-level items), the analogy between a Subchapter S election on the one hand and the liquidation of a Subchapter C corporation followed by the formation of a partnership by the former shareholders on the other hand becomes even stronger.

Although, in substance, a Subchapter S election and a liquidation are quite similar, their tax treatment is quite different. When a corporation is liquidated under section 331, there is a capital gains tax imposed on the shareholders, measured by the difference between the fair market value of the property they receive and their basis for their stock (a "stock basis capital gains tax").1/ In

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1/In certain situations described in the "collapsible corporation" provisions of section 341, this gain may be taxed at ordinary income rates.

addition, there are various recapture taxes at the corporate level. Finally, the shareholders take a fair market value basis in the property distributed to them. However, when a corporation elects Subchapter S, there is no tax imposed and the corporation's basis for its assets is unchanged.

To take the comparison a little further, suppose that the corporation has an active business and the shareholders wish to sell the business and invest the proceeds in marketable stocks and securities. If they liquidate the corporation under section 337, there will be no tax determined with reference to the corporation's basis in its assets on the sale of the business (except for recapture taxes) but there will be a stock basis capital gains tax imposed on the shareholders upon liquidation. If they elect Subchapter S and sell the business, there will be a capital gains tax imposed on the difference between the amount realized on the sale of the business and the corporation's basis in the assets being sold (an "asset basis capital gains tax") plus recapture taxes. (We are assuming in our analysis that section 1378 of current law would not apply). However, no stock basis capital gains tax will be imposed for the privilege of lifting the corporate income tax from the corporation's future income.

In analyzing the difference between the stock basis capital gains tax and the asset basis capital gains tax, it is instructive to focus upon the corporation's accumulated earnings and profits account. If the corporation has no accumulated earnings and profits, then the stock basis capital gains tax and the asset basis capital gains tax will be approximately the same. However, if the corporation has accumulated earnings and profits, then the asset basis capital gains tax will generally be lower than the stock basis capital gains tax, with the difference being generally attributable to the amount of the accumulated earnings and profits.[2] Another point which accentuates the importance of the accumulated earnings and profits account is that, if the corporation has no accumulated earnings and profits, the corporation can generally be liquidated tax-free under section 333. Thus, if the corporation has no accumulated earnings and profits, there is no great advantage (in terms of the liquidation analogy) to electing Subchapter S as opposed to liquidating the corporation.

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[2] The difference may not be exactly attributable to the amount of the accumulated earnings and profits because of such factors as section 312(k) adjustments and intervening sales of stock.

If a corporation has accumulated earnings and profits, the Subchapter S election gives the corporation's shareholders a choice. If they merely wish to eliminate the corporate tax on the corporation's future income, they can use the Subchapter S election to accomplish this without the payment of any tax. If they wish to sell the corporation's business, invest the proceeds in passive investment assets, and lift the corporate tax from the income on these assets, they can use the Subchapter S election to accomplish this with the payment of a asset basis capital gains tax rather than a stock basis capital gains tax. Since the stock basis capital gains tax would usually be higher than the asset basis capital gains tax, the Subchapter S route would usually result in a lower tax. 3/

The bill addresses this problem by forbidding a corporation from electing Subchapter S if it has accumulated earnings and profits and its passive receipts exceed 20 percent of its gross income. In effect, this would prevent a corporation from electing Subchapter S, selling off its active business assets, and using the proceeds to purchase passive investment assets. However, the bill would not prevent an active business corporation with accumulated earnings and profits from electing Suchapter S and thus lifting the burden of the corporate tax without the payment of a stock basis capital gains tax. In providing these results, the bill simply preserves current law on the question of when a corporation may use a Subchapter S election to lift the burden of the corporate tax without the payment of a stock basis capital gains tax.

The bill also provides that, for corporations with accumulated earnings and profits, distributions in excess of the corporation's "accumulated adjustment account" (essentially includible income minus deductible expenses which was not previously distributed) are considered to be out of accumulated earnings and profits and therefore are taxable as dividends. Also, when a Subchapter S corporation distributes appreciated property (other than in complete liquidation), the bill would require the distributing corporation to recognize the gain. Thus, although the bill does not require a tax to be paid on accumulated earnings and

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3/ It is true that an actual liquidation results in a stepped up basis in the corporation's assets in the hands of the shareholders while the mere election of Subchapter S does not. However, if the stock of the Subchapter S corporation is held until the shareholder's death, the basis of the stock is stepped up under section 1014 and the corporation can then be liquidated without the payment of a stock basis capital gains tax to get the stepped-up asset basis.

profits when Subchapter S is elected, the bill requires a dividend tax to be paid when a subchapter S corporation extracts previously accumulated earnings and profits.

The issue is thus what restrictions or costs should be imposed upon the election of Subchapter S by a corporation with accumulated earnings and profits.

There appear to be three alternatives: (i) treating the election of Subchapter S as a liquidation of the electing corporation; (ii) the solution currently in the bill; and (iii) imposing some type of modified liquidation tax upon the election of Subchapter S.

We believe that treating the election of Subchapter S as a liquidation is the closest of the three to the correct theoretical result. However, we note that the election of Subchapter S is not identical to a liquidation -- e.g., there is no stepped-up basis in the corporation's assets and the assets remain in corporate solution for state law purposes -- and we are mindful that, in many quarters, the imposition of a liquidation tax would be perceived as unacceptable.

We think the approach of the bill (which is generally the approach of current law) has both advantages and disadvantages. The principal advantage of the bill's approach is that it provides an incentive for corporations electing Subchapter S to pay out their accumulated earnings and profits to avoid the ever-present threat of disqualification under the passive income test. Thus, it provides an incentive for corporations to enter Subchapter S under the simplified no-earnings-and-profits regime. The other advantage of the bill's approach is that it maintains the present law barrier to the use of Subchapter S by Subchapter C corporations with accumulated earnings and profits which wish to sell off their businesses and invest in passive assets.

There are two principal disadvantages, however, to the bill's approach. First, the incentive to come within the simplified rules will not be strong enough to encourage companies with substantial accumulated earnings and profits to pay them out as dividends. Thus, both the accumulated earnings and profits account and the passive income test will be retained for a substantial class of Subchapter S corporations, bringing with it complexity and the possibility of inadvertent termination, both of which the bill elsewhere strives to eliminate. Second, there is no real conceptual difference between the case where Subchapter S is elected, the active business is sold off and the proceeds invested in passive assets and the case where Subchapter S is elected and the active business is retained. In both cases, the shareholders are achieving the principal benefit of a liquidation -- the lifting of the corporate tax -- and, therefore, the imposition of a liquidation-type tax would be appropriate. On balance, we feel that these disadvantages are sufficiently serious to warrant exploring other approaches. Therefore, we turn to the third alternative.

We view the development of a modified liquidation tax as a promising approach to this problem. To be sure, there are many significant issues that must be resolved in fashioning such a tax. Some of the most important are:

(i) The amount subject to tax. Presumably, by reference to the liquidation model, the modified liquidation tax would be a capital gains tax upon the corporation's accumulated earnings and profits. In support of taxing only accumulated earnings and profits, it may be argued that a section 333 liquidation generally taxes only the accumulated earnings and profits (albeit at ordinary rates). Also, it may be argued that the tax on the corporation's unrealized appreciation in its assets (which is, in general, the other component of the shareholders' appreciation in his stock apart from the corporation's accumulated earnings and profits) is generally offset, for depreciable assets, by depreciation or cost recovery deductions which the shareholder may take with respect to the stepped-up basis of the assets in the shareholder's hands. On the other hand, it should be noted that for certain assets (land and good will, for example) there would be no such offset.

(ii) Period of time for paying the tax. Another issue is whether the modified liquidation tax should be payable over a period of time longer than one year. The argument in favor of the longer time period is that paying a large capital gains tax in one year might cause liquidity problems and, therefore, might be a deterrent to the election of Subchapter S. If there is a more-than-one-year period for payment of the tax, the appropriateness of an interest charge would have to be considered.

(iii) Anti-bailout provisions. There would, of course, have to be anti-bailout rules to prevent shareholders from shifting from Subchapter C to Subchapter S in order to bail out earnings at capital gain rates and then returning to Subchapter C.

(iv) Alternative to paying the modified liquidation tax. Another important issue is whether payment of the modified liquidation tax would be the only means by which a corporation with accumulated earnings and profits could elect Subchapter S or whether there would be an alternative, *e.g.*, being subject to current law rules such as the passive income limitation instead of paying the modified liquidation tax. Consideration must be given to such matters as the reliance interest of existing Subchapter S and C corporations; the complexity for the tax law of having two sets of Subchapter S rules; and the correctness under the liquidation model of allowing a Subchapter C corporation with accumulated earnings and profits to elect Subchapter S without any payment of tax. Consideration should also be given to the possibility, at least with respect to Subchapter C corporations, of "sunsetting" after a period of years the alternative to payment of the modified liquidation tax.

Although these are difficult issues, this approach reduces the tax burden of eliminating the accumulated earnings and profits account such that more corporations with accumulated earnings and profits will presumably incur the tax in order to come under the new simplied rules. We look forward to working with your Committee and the other participants in this project in pursuing this alternative further.

The "Second Class of Stock" Problem

Under current law, a Subchapter S corporation may only have a single class of stock. In a number of cases, the Internal Revenue Service has argued that certain purported debt instruments should be treated as a second class of stock, thus invalidating a Subchapter S election. See, *e.g.*, *Portage Plastics Co., Inc. v. U.S.*, 486 F.2d 632 (7th Cir. (1973); *James L. Stinnet*, 54 T.C. 221 (1970). The Service has been unsuccessful in these attempts and, almost ten years ago, announced that it would not continue to litigate cases "factually similar" to those in which its "second class of stock" arguments had been rejected by the courts. See T.I.R. No. 1248 (July 27, 1973). Nevertheless, the question of when purported debt instruments will be treated by the Service as a "second class of stock," thus terminating a Subchapter S election, remains a source of uncertainty in the tax law.

The text of the bill does not address this question. It simply retains the single class of stock requirement without further elaboration. However, in their floor statement accompanying the introduction of the bill, Chairman Rostenkowski and Mr. Conable indicate that further consideration of this question is invited. Treasury would like to take this opportunity to analyze this issue in some detail.

The reason for the single class of stock requirement is that the existence of multiple classes of stock would make it too difficult to allocate a Subchapter S corporation's income and loss among the corporation's stockholders. Treasury believes that the rationale for this rule is sound and that the rule must be retained.

As a corollary of our belief that the single class of stock requirement must be retained, we believe it should not be possible for Subchapter S corporations to bypass the requirement by issuing instruments which are debt in form but which in substance are stock. Thus, it becomes necessary to examine purported debt of a Subchapter S corporation to determine whether it should be treated as debt for tax purposes or as a prohibited second class of stock.

In particular, there are two abuses posed by instruments issued by Subchapter S corporations that are debt in form but stock in substance. First, these instruments could be held by persons who would be ineligible to be shareholders of Subchapter S corporations (e.g., nonresident aliens or corporations). Thus, these instruments could be used to circumvent the limitations on who can be a Subchapter S corporation shareholder.

Second, these instruments could be used to achieve an allocation of income or loss for tax purposes which differs from the actual economic allocation of this income or loss. The purported debt holder might share the economic losses equally with the shareholder while the tax loss was passed through solely to the shareholder. This violates the general tax principle that tax losses should be deductible by the taxpayer suffering the economic loss.

> Example.
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> Individuals A and B form a Subchapter S corporation. A invests \$200 in exchange for all of the corporation's common stock and \$100 of unsubordinated debt. B also invests \$200, but in exchange for a \$100 subordinated income bond and \$100 of unsubordinated debt. Under the terms of the income bond, B is entitled to a \$6 annual payment out of earnings and is entitled to share equally with A in the profits of the corporation after A has received a \$6 dividend on the common stock. In its first year of operation, the Subchapter S corporation incurs a loss of \$200. As an economic matter, the loss will be borne half by A and half by B. However, for tax purposes, the Subchapter S provisions would pass the entire loss through to A because B is not a "shareholder."

In order to prevent distortions of this type, it becomes necessary to scrutinize whether purported debt instruments such as the subordinated income bond in the example should be treated as debt or stock for tax purposes.

Having set forth our general concerns in the "second class of stock" area, we now turn to a more specific discussion of what we believe to be a sensible approach to reclassifying various types of straight and hybrid debt instruments as a second class of stock, thus disqualifying a Subchapter S election.4/

The issue is when purported debt which is treated as equity for tax purposes under applicable debt-equity rules (either the case law or the section 385 regulations) should be treated as a second class of stock, thus disqualifying a Subchapter S election. In general, we believe that straight debt instruments which are equity under applicable debt-equity rules should never be reclassified as a second class of stock so as to disqualify a Subchapter S election. The bill provides certain carefully-tailored rules -- and certain additional rules will be necessary -- to prevent the use of such debt to achieve unwarranted tax advantages. For hybrid debt instruments (*i.e.*, debt convertible into stock and debt providing for contingent payments), we believe that the possibility of reclassification of such instruments as a prohibited second class of stock is necessary to prevent tax avoidance. A more detailed discussion of these conclusions follows.

Straight Debt Instruments

(a) Purported straight debt instruments not issued proportionately. When straight debt instruments are not issued proportionately, then under both the existing case law and the proposed regulations under section 385, the instruments are generally treated as debt for tax purposes. Treasury believes this is the correct result in the Subchapter S context as well.

(b) Straight debt instruments issued proportionately. Straight debt instruments issued proportionately pose more difficult questions. For purposes of discussion, it is useful to distinguish between "pure" proportionality and "constructive" proportionality. In the case of pure proportionality, the same person owns the stock and debt. Two examples of this are the sole shareolder who also owns 100 percent of the debt and the two 50-percent shareholders

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4/For purposes of this discussion, we have assumed that hybrid instruments are instruments which are convertible into stock or which provide for contingent payments to the holder (e.g., an income bond) and straight debt instruments are debt instruments other than hybrid instruments. Also, for purposes of this discussion, instruments are considered to be issued proportionately if holdings of the instruments and the issuing corporation's stock are proportionate. Thus, for example, if a Subchapter S corporation issued $25,000 of debt to each of its two 50-percent shareholders, the debt would be considered to be issued proportionately.

who each own 50 percent of the debt. In a case of constructive proportionality, the holders of the stock and debt are different persons who, because of their relationship, might not act in an arm's-length manner with respect to one another. An example of constructive proportionality would be where an individual was the sole shareholder of a corporation and the individual's father was the owner of all of the corporation's debt. We do not believe that pure and constructive proportionality are sufficiently well defined to form the basis of a statutory distinction; however, we see them as useful concepts for elucidating our policy concerns.

(i) Straight debt instruments issued with pure proportionality. When straight debt instruments are issued with pure proportionality, the concerns about having a second class of stock masquerading as debt are not present. First, there is no problem with the allocation of income and loss to the shareholders. Because of the existence of pure proportionality, the allocations that would result if the purported debt were treated as stock are no different from the allocations that would result if the purported debt were respected as debt.5/ Thus, the policy of avoiding complex allocations of income and loss among different classes of stock does not require the reclassification of pure proportionate debt as a second class of stock.

Second, since the holders of the purported debt are already shareholders, these persons must be eligible to be shareholders in a Subchapter S corporation (*e.g.*, not nonresident aliens or corporations). Thus, the policy of preventing circumvention of the limitations on eligible shareholders does not require the reclassification of pure proportionate debt as a second class of stock.

Therefore, in the case of pure proportionate straight debt, Treasury believes that such debt should not be reclassified as a second class of stock so as to terminate a Subchapter S election.

(ii) Straight debt issued with constructive proportionality. In the case of straight debt issued with constructive proportionality, the policy concerns relating to a second class of stock do apply.

5/There may be timing differences and differences arising from the conversion of operating income into interest income. However, these can be dealt with more directly, as discussed below.

First, there is a problem in that the holder of the purported debt may be a person not eligible to be a Subchapter S corporation shareholder. For example, a Subchapter S corporation might issue all of its stock to an individual for a nominal investment and a large amount of straight debt to a corporation wholly owned by the individual or to a nonresident alien relative of the individual. In this case, the debt is being used to circumvent the limitations on permissible Subchapter S corporation shareholders. A solution to this problem might be to require that, in cases of constructive proportionality, the holder of the debt must be a person who would be eligible to own stock in a Subchapter S corporation.

Second, there are potential problems of income allocation when there is constructive proportionality. Consider, for example, the case where an individual owns all of the stock of a Subchapter S corporation and his father owns all of the debt. By setting a very high or very low interest rate on the debt, the parties can allocate the income between father and son and, because of their relationship, the motivation for such allocation may be tax avoidance. Under the bill, current section 1375(c) is expanded to empower the Internal Revenue Service to make appropriate adjustments when an individual who is a member of the family of a Subchapter S corporation shareholder furnishes capital to the corporation without receiving reasonable compensation therefor. Treasury regards this provision as an appropriate means to prevent this type of tax-motivated income allocation.

In sum, Treasury feels that the problems posed by straight debt instruments held with constructive proportionality can be dealt with by carefully-tailored provisions aimed at specific abuses rather than by the more drastic method of reclassifying the instruments as a second class of stock. We think the bill deals adequately with the income allocation abuse described above and we think a tailored provision can be designed for the other abuse for which the bill does not presently provide a solution. We are continuing to study this area to determining whether further measures of this type would be necessary.

Hybrid Instruments

Hybrid instruments is the one area where we feel it is very important to retain the possibility of reclassifying a hybrid instrument as a second class of stock. Both of the policy concerns with equity masquerading as purported debt -- the problem of the ineligible shareholder holding the debt and the problem of income and loss allocation solely for tax effect -- are present for hybrid instruments.

As an example of the first problem, consider a Subchapter S corporation which issues a "debt" instrument for $100 to N, a nonresident alien. Under the terms of the instrument, N is entitled annually to 50 percent of the net profits of the corporation. A, a U.S. citizen buys the common stock for $100. It seems clear that N's "debt" instrument should be treated as stock and that the corporation should therefore be ineligible to elect Subchapter S.

An example of the second problem was set forth previously in the general discussion of the "second class of stock" issue. This example demonstrated how a subordinated income bond could be used to allocate all of the losses to the shareholder although, as an economic matter, half of the losses were borne by the bondholder.

In view of these potential abuses, we currently think it is important to preserve the possibility that a hybrid instrument may be reclassified for tax purposes as a second class of stock, thus disqualifying a Subchapter S election. The standard for determining whether a hybrid instrument would be reclassified as a second class of stock would be the current debt-equity case law or, when they go into effect, the rules applicable to hybrid instruments under the proposed section 385 regulations. There are two reasons why we currently favor this approach.

First, we believe that hybrid instruments are issued not by less sophisticated small businesses but, rather, by well-advised taxpayers who are familiar with the tax laws. Thus, the possibility of disqualification does not pose the proverbial "trap for the unwary."

Second, we believe that the danger of well-advised taxpayers using hybrid instruments issued by Subchapter S corporations as a means of tax avoidance is very real and the possibility of disqualification would serve as a deterrent to such use.

Thus, although we would certainly consider a more tailored approach, our present view is that the possibility of a hybrid instrument's being reclassified as a prohibited second class of stock should be preserved.

An additional tax avoidance use of excessive debt should be noted. With respect to both straight debt and hybrid instruments, shareholders could use excessive debt to convert operating income into interest income. For example, if a Subchapter S corporation issued only stock to its shareholders, then the shareholders would take into account a pro rata share of the corporation's operating income and deductions, with the character of the income and deductions passing through to the shareholders. If, however, the corporation issued to its shareholders a nominal amount of stock and large amounts of debt, then the net operating income might be offset by a large interest deduction and the shareholders would take into account a large interest payment instead of a share of operating income and deductions. This is an unwarranted planning opportunity which might be used, e.g., to generate investment income under section 163(d). Treasury believes, however, that this potential abuse can be addressed with a tailored provision aimed at this particular problem, rather than by the more drastic remedy of reclassification as a prohibited second class of stock.

Finally, the bill makes it unnecessary to convert the purported debt into equity solely to eliminate potential timing benefits which might be achieved as a result of accruing interest that may not be paid. Suppose that A and B are each 50-percent shareholders of a Subchapter S corporation and that B lends money to the corporation. If interest on the loan is accrued but not paid and the corporation is an accrual basis taxpayer while B is a cash basis taxpayer, then the interest is deductible by the corporation (in effect, half by A and half by B) but not includible in B's income. Under current law, this transaction is beyond the reach of section 267, which is designed to prevent abuses of this sort. Under the bill, section 267 is amended to provide that, with respect to interest payments and expenses deductible under sections 162 or 212 paid to a cash basis taxpayer, payments between a Subchapter S corporation and certain related parties -- including a 2 percent direct or indirect shareholder of the Subchapter S corporation -- are not deductible to the payor before the day the payment is includible by the payee. Thus, in the above example, the interest would not be deductible by the Subchapter S corporation until it was actually paid to B. Treasury believes this provision will prevent this kind of timing abuse.

The foregoing discussion of the "second class of stock" issue is intended not as a blueprint for a new statutory scheme but, rather, as a discussion of the Treasury's view of the conceptual issues involved. We hope that it will serve as a springboard for continued consideration of this difficult issue.

Finally, in the interest of brevity, we have not attempted a technical discussion of the bill beyond the "C to S" and the "second class of stock" issues. For example, we have not addressed the pension provisions of the bill, an area in which we have recently testified before the full Committee, the appropriate treatment of warrants in the second class of stock context, and the proper treatment of purported debt which is treated as equity under Subchapter C but is deemed not to violate the Subchapter S second class of stock requirement. We hope to continue working with the Committee to resolve these and other technical issues that necessarily arise in a measure of such substantial scope.

Chairman **Stark**. If you take a professional corporation or a service corporation, let's just assume that they have absolutely no tangible assets. Somebody just has a corporation, a group of entertainers or whatever, and then subchapter S is a way to avoid double taxation. Let's assume everybody is paying roughly 50 percent corporate and 50 percent personal.

So you just drop a notch. You end up paying 50 percent rather than 70 percent a year. Is that basically what we allow people to do?

Mr. **Glickman**. I think the reduction of rates puts the corporation and the individual on much more of a parity.

Chairman **Stark**. Let's assume they are almost even. You just avoid one notch or you do not tax it twice?

Mr. **Glickman**. You eliminate the corporate level tax.

Chairman **Stark**. Also we have this huge industry out there, the real estate industry with limited partnerships which really does not have any problem. They really can do everything that a widget company can do without even fussing with the corporation. They can shelter income, they can build it up in their partnership or distribute it if the partners are cash basis taxpayers, they have to take it.

I suppose they cannot shelter. The only reason then for a C, how much can you build up, $100,000, before there is a presumption?

Mr. **Glickman**. I think it is $150,000.

Chairman **Stark**. So that is probably the only advantage, for this corporation to go into C, except maybe they can own automobiles and things like that.

My feeling would be that they should be as flexible, particularly on the multiple shares of stock and the number of shareholders. I do see the question getting from one mode to the other, and I guess you have to pay at some point.

But your concern is building up tremendous amounts of real assets, tangible assets, and then really liquidating them and converting to a subchapter S and having mutual funds?

Mr. **Glickman**. Let me make one observation. As we compare a partnership and a subchapter S corporation moving them closer together, obviously raised many questions in many people's minds as to whether we ought to do away with subchapter S and subchapter K and come up with one passthrough type of entity.

Now I do not want to mislead. There are a number of problems in subchapter K also.

Chairman **Stark**. You mean where you have to distribute your earnings to shareholders each year?

Mr. **Glickman**. Partnerships do not have to distribute.

Chairman **Stark**. Where the shareholder takes the income in each year.

Mr. **Glickman**. That is what subchapter S does also. I am just saying that they are both passthrough type of entities. Thus there has been discussion as to whether we ought to put them both together and have only one type of passthrough entity. That in my mind, if we had the time to do it, might be the best way to go.

However, there are many problems in subchapter K, which means then we are talking about not only a total revision of subchapter S, but a total revision of subchapter K also.

Chairman **Stark**. That is the partnership?

Mr. **Glickman**. Yes; that is the partnership rule. There are a number of problems in that area also. There has been a great deal of discussion by ALI, they have had projects going on subchapter K for a number of years. What we are doing is moving the two much closer together and I think there is a great deal of merit to that.

If we could cut it off and start a brandnew world where everybody who went into a subchapter S corporation was a brandnew corporation, we would not have any problems. The problems we are faced with are mostly those subchapter C corporations that want to move into subchapter S. The professionals you are talking about, if they have no assets which have appreciated in value, perhaps the problem may not be as severe, although I guess they could have receivables also, and the question comes in that context, what do you do with receivables when you distribute them.

There is also a problem I have always had with good will. If you liquidate a corporation that has built up a lot of good will, that can generate gain. So there may be a problem even in the personal service type of corporation.

But overall, it seems to me that the major problem here is trying to figure out what type of—if you want to call it that—toll has to be extracted when you move from the subchapter C to the subchapter S. Again, even though you have these assets that have appreciated in value, I think that the major problem is not that situation but the situation where you have built up the earnings and profits over the years, where that amount has been taxed once at the corporate level.

But in our two-tax structure, you are now allowing that money to come out without the second tax being applied to it, and if you hold on to the corporation's stock long enough, until death, for example, the basis of all of the assets will be stepped up and you will avoid forever the second tax.

But these are, it seems to me, the major hurdles that we are facing here. The hurdle or major problem, let me say it that way.

Chairman **Stark**. I do not even want to begin to think about it. What happens, if Senator Dole has his way we get a minimum corporate tax. That does not apply to a subchapter S. It is a minimum personal tax that you calculate. You take the subchapter S income when you calculate your own individual minimum tax.

Mr. **Glickman**. What you would do under the bill is very similar to the way a partnership is now treated. Every item of income and deduction will flow through and retain its character, just like in the partnership context.

And thus, it will be applied at the individual level obviously rather than the corporate level.

Chairman **Stark**. Thank you very much. I have one other question I did want to raise. This bill would prohibit insurance companies from electing subchapter S and I assume that means all issurance companies. But also under the 1974 ruling, life insurance companies cannot elect and casualty companies can.

Is there some reason for that change, or did you just decide that all insurance companies should be the same?

Mr. **Glickman**. I think in the insurance company taxation area, there are many accounting methods that are involved, and the question has come up as to whether it is appropriate to allow those accounting methods to be passed through to the individual.

There is also under consideration right now an issue concerning whether anything other than a corporation could even be taxed as an insurance company. In other words, whether a partnership can be taxed this way.

It seems to me that until those type of issues are really answered, it is very difficult to say that we ought to allow insurance company tax treatment to pass through. Although again I think whatever we did here, we would want to have a grandfather type of rule that for those companies who have been subchapter S corporations so that we would not have a sudden change in rules with respect to them.

Chairman STARK. In other words, life insurance companies would not change. It is a question whether casualty companies will no longer be able to be treated as subchapter S?

Mr. GLICKMAN. That is the issue——

Chairman STARK. The only ones who would do that would be the Lloyds groups?

Mr. GLICKMAN. Lloyds as I understand it is more a partnership mode right now, anyway.

Chairman STARK. But companies here, in America, who become Lloyds brokers, are they the only ones using it or——

Mr. GLICKMAN. No, there are other corporations as I understand it right now that have used it, not foreign entities, domestic entities who have used it. The subchapter S mode is what I am talking about. So that this is a problem that is a domestic problem, as well possibly as a foreign problem.

Thank you.

Chairman STARK. Our first panel will consist of John Nolan, chairman of the tax section of the American Bar Association; William Diss, chairman of the small business taxation subcommittee of the American Institute of CPA's; and Richard Shaw, chairman of the California State Bar Association tax section.

Gentlemen, I am going to run the light on you, as it were. But if there is something you think you could do beyond your 5 minutes alloted of summary to influence me, go right ahead. The flashing gives you an idea that you have taken 5 minutes.

I will let you violate the stoplight if you wish. Your full testimony will be made part of the record. As I said earlier, we may want to submit written questions. We would ask you to respond in writing. And I ask that you summarize for us, with particular reference to those issues that Secretary Glickman touched on.

Mr. Nolan, would you proceed?

STATEMENT OF JOHN S. NOLAN, CHAIRMAN, SECTION OF TAXATION, AMERICAN BAR ASSOCIATION

Mr. NOLAN. Thank you, Mr. Chairman.

I am John S. Nolan, chairman of the section of taxation of the American Bar Association. We strongly support enactment of H.R. 6055. We have been intensively engaged in developing this bill over the past several years in a collegial process involving the congressional staffs, the Treasury Department, and the American Institute of Certified Public Accountants. We focus upon discrete areas of the tax system affecting large numbers of taxpayers which present particularly difficult complexity problems. We undertake to rationalize, improve, and simplify those areas, one at a time, in a practical and achievable manner.

We are particularly pleased that our joint undertaking as to subchapter S is coming to fruition because subchapter S affects large numbers of small businessmen. It provides an opportunity in this bill through tax simplification to encourage new business undertakings and the allocation of capital to research, development, risk-taking, and employment in the most efficient possible manner without undue tax burdens.

Subchapter S, dealing with small business corporations, has been severely criticized, and has been underutilized, because of the extreme complexity of its provisions. The reduction in individual tax rates, particularly the top individual rate from 70 percent to 50 percent, in the Economic Recovery Tax Act of 1981 makes subchapter S potentially much more useful to small business if some of the complexities could be removed. H.R. 6055 would greatly simplify the rules relating to eligibility for and the operation of subchapter S status.

We support increase in the number of permitted shareholders to 35. It will permit wider use of subchapter S and provide an added margin of safety against inadvertent terminations. We question the need for denial of the use of subchapter S corporations with DISC subsidiaries or foreign subsidiaries. We support the provisions of H.R. 6055 that differences in voting rights in common stock would not violate the one class of stock requirement.

The subcommittee has requested comment on the question whether the section 385 regulations should apply. They should not apply as such; they would create undesirable and unnecessary complexity and uncertainty in the subchapter S area. We urge instead that a simple provision be adopted that an instrument issued for cash will not be deemed to be stock for any subchapter S purpose unless over one-half the value of the instrument is attributable to an equity feature that permits the holder to participate in the income of the corporation. This test, taken from the proposed section 385 regulations for hybrid instruments not held proportionally to shareholdings, would be specifically in lieu of any application of the section 385 regulations.

We strongly urge complete elimination of the existing personal holding company income limitation for subchapter S corporations which do not have accumulated earnings and profits. In this connection, the subcommittee has also particularly requested comment as to the treatment of a corporation which has accumulated earnings and profits and seeks to make a subchapter S election. We conclude for reasons set forth in my written statement that special rules are necessary in such a case. In lieu of the provisions of H.R. 6055, we recommend a so-called two-track approach. Under one track, a corporation with E. & P. making a subchapter S election with the consent of its shareholders could elect to treat the E. & P. as income to the shareholders ratably over 5 years, subject to a gain limitation. The gain to be reported would be the lesser of the shareholder's share of E. & P. or an amount equal to the gain that would have been realized if on the date of the subchapter S election the shareholder had sold at fair market value all of his shares in the corporation. Twenty percent of the gain would be reported in each of the 5 years.

For other corporations not electing shareholder taxation of E. & P., we recommend a qualification test for subchapter S based specifically on the personal holding company income rules of Code section 543 with modifications to deal with certain types of interest and rental income that are clearly "active" income. We propose somewhat broader application of proposed new Code section 1374, imposing a corporate tax on certain large capital gains, to such corporations. It should apply unless the election has been in effect for 5 years. It should also apply to an installment sale within a 5-year period following the subchapter S election to the extent principal is paid during the 5-year period.

We urge deletion of the provision terminating a subchapter S election if the corporation has foreign source income. This restriction is unnecessary.

We support the new provisions with respect to the election, revocation of the election, and termination of the election. These greatly simplify subchapter S but would still prevent tax abuse. We particularly support the provision giving discretion to the Internal Revenue Service to permit continued Subchapter S treatment notwithstanding an inadvertent termination. We suggest that the Service be encouraged to exercise this discretion fully and reasonably.

Responding to the subcommittee's question, we think the bill greatly simplifies the determination of income of the shareholders. Preserving the character of all items of income, deduction, loss, and credit to the shareholders, in the same manner as partnerships, will be a great improvement. Per share, per day, allocation to shareholders is more accurate and reasonable and will prevent tax abuse from income-shifting. We support the provisions for carryover of losses in excess of basis, similar to partnership treatment.

We support the new taxable year rules requiring use of a calendar year unless the corporation can show a business purpose for another accounting period. This will prevent unjustified tax deferral.

We favor the rule for property distributions in proposed code section 1368 for distributions from corporations which have E. & P. and which have not elected shareholder taxation of such E. & P. Long-term capital gain property distributions from corporations which have elected shareholder taxation of their E. & P., or corporations which have always been subchapter S corporations, should be taxed, however, only under rules similar to the partnership rules.

We strongly oppose the provisions imposing the partnership—self-employed—rules for qualified pension and profit-sharing and fringe benefit purposes. These are unfair and unnecessary. They would effectively deny the benefits of subchapter S to many small businesses.

Shareholder-employees of a subchapter S corporation should be treated the same as shareholder-employees of any other closely held corporation. There is nothing in the nature of subchapter S that calls for different treatment. Shareholder-employees of a subchapter S corporation must satisfy the reasonable compensation test for qualified plan purposes to the same extent as shareholder-employees of any other corporation.

The correct treatment in these areas is equality of treatment of all persons who have personal service earnings, whether self-employed or corporate employees. H.R. 6410 introduced recently by Congressman Rangel moves importantly in this direction, though it is incomplete in some important respects and creates new discriminations in other respects. I urge this subcommittee to consider my testimony on behalf of the American Bar Association in the hearings on H.R. 6410 on June 10, 1982. I also urge the subcommittee to consider the testimony of the Treasury Department on that bill; the Treasury supported the principle of equality of treatment of all persons with personal service earnings.

In conclusion, the section of taxation enthusiastically supports the enactment of H.R. 6055 with certain modifications. It is the next step in the collegial process I described, and it will greatly simplify taxation for a very large segment of small business. Favorable action on H.R. 6055 will be an important signal to the participants in the collegial process to continue with their vital work. There is more on the way, and we urge this subcommittee to join us in supporting simplification of the tax system in ways that realistically can be accomplished.

Thank you.

Chairman STARK. Thank you very much, Mr. Nolan.

[The prepared statement follows:]

STATEMENT OF JOHN S. NOLAN, CHAIRMAN, SECTION OF TAXATION, AMERICAN BAR ASSOCIATION

H.R. 6055: THE SUBCHAPTER S REVISION ACT OF 1982

My name is John S. Nolan. I am Chairman of the Section of Taxation of the American Bar Association, an organization of 25,000 tax lawyers throughout the United States. I will present the position of the Section with respect to H.R. 6055, the Subchapter S Revision Act of 1982. I speak only for the Section; the American Bar Association has not adopted a position on this bill.

The Section of Taxation strongly supports the enactment of H.R. 6055. The Section has been intensively engaged in developing this bill over the past several years in a collegial process involving the staff of the Joint Committee on Taxation, the staffs of the House Ways and Means and Senate Finance Committees, the Treasury Department, and the American Institute of Certified Public Accountants. It is another step in this ongoing collegial process, following development and enactment of the Installment Sales Revision Act of 1980, to simplify the tax system in a practical and achievable manner.

In this collegial process, the Section and the groups named above focus upon discrete areas of the tax system affecting large numbers of taxpayers which present particularly difficult complexity problems. We undertake to rationalize, improve, and simplify those areas, one at a time. We have many other such projects "in the pipeline". We are particularly pleased that our joint undertaking as to Subchapter S is coming to fruition because it affects large numbers of small businessmen. It provides an opportunity through tax simplification to encourage new business undertakings and the allocation of capital to research, development, risk-taking, and employment in the most efficient possible manner without undue tax burdens.

Subchapter S, dealing with "small business corporations", was first enacted in 1958 and has been amended on a piecemeal basis during the intervening years. It has been severely criticized, and has been under-utilized, because of the extreme complexity of its provisions. The reduction in individual tax rates, particularly the top individual rate from 70% to 50%, in the Economic Recovery Tax Act of 1981 makes Subchapter S potentially much more useful to small business if some of the complexities and limitations in Subchapter S could be removed. H.R. 6055 would greatly simplify the rules relating to eligibility for and the operation of Subchapter S status.

We are submitting separately a number of suggested technical changes to the bill. In this statement, we address the basic merits of H.R. 6055, including (as requested by this Subcommitee) the application of Code §385 to Subchapter S status and the conversion of a corporation with accumulated earnings and profits to a Subchapter S corporation.

The Subchapter S provisions were enacted into law in 1958 for the announced purpose of -- (1) allowing businesses to select their legal form free of undue tax influence; (2) aiding small business by taxing a corporation's income to its individual shareholders who may be in lower brackets than their corporations; and (3) permitting the shareholders of corporations that are suffering losses to offset the losses against individual income from other sources. To protect against possible revenue losses and potential abuses, various restrictions and limitations were imposed upon the availability of the election. Twenty-four years of working with Subchapter S has demonstrated that the restrictive provisions create hardships, anomalies, inadvertent terminations of elections, and complexity of enforcement and administration, both for the Internal Revenue Service and for taxpayers.

Congress dealt with certain of the problems by successive amendments to Subchapter S. It has been evident for some time, however, that an overall simplification of the Subchapter S provisions is required. The Subchapter S Revision Act of 1982 substantially accomplishes the necessary simplification. The following analysis focuses upon the most important aspects of the proposed revisions.

ELIGIBILITY

H.R. 6055 increases the number of permitted shareholders of the Subchapter S corporation from 25 to 35. The increase in the number of shareholders will permit more widespread use of Subchapter S by small business. It will also conform the number of permissible shareholders to the numerical limits of federal securities laws for private offerings. It will provide an additional margin of safety to avoid the permitted number being exceeded as a result of death of a shareholder and ownership by his heirs.

H.R. 6055 introduces a new concept, "ineligible corporation", to describe several categories or companies which would not be permitted to make a Subchapter S election. Some of these groups of companies are eligible under existing law. These categories include financial institutions, insurance companies, possession corporations, and corporations having DISC subsidiaries or foreign subsidiaries. We question the application of this provision for corporations with DISC subsidiaries or foreign subsidiaries. We see no necessity of excluding such a parent corporation.

H.R. 6055 also changes the existing provision excluding corporations which have more than one class of stock. Differences in voting rights in common stock would not violate the one class of stock requirement. This is a very desirable change. We strongly support it.

APPLICATION OF SECTION 385

The application of §385 of the Internal Revenue Code of 1954 to Subchapter S corporations presents difficult considerations. While we are convinced that §385 as such should have no application to Subchapter S, that does not fully answer the question. The question whether an instrument constitutes debt or equity affects several aspects of Subchapter S. Thus, under H.R. 6055, this determination will affect: (1) the eligibility of shareholders; (2) the allocation of income, considering both family allocation problems and individuals with differing tax status; and (3) distributions to shareholders. Application of §385 as such would bring undesirable complexity and uncertainty to each of these areas. There would be uncertainty whether there was only one class of stock, as to the number of shareholders, whether a corporate lender was a "shareholder" (thus disqualifying the corporation), and whether distributions to a "lender-shareholder" would affect distributions to other shareholders.

We nonetheless recognize that problems exist in the debt-equity area that must be resolved, particularly with respect to the allocation of income. We also recognize that without any rules, there would be equally undesirable uncertainty, especially as to hybrid instruments having both debt and equity features. We therefore recommend that a provision be adopted that an instrument issued for cash will not be deemed to be stock for any Subchapter S purpose unless over one-half of the value of the instrument is attributable to an equity feature that permits the holder to participate in the income of the corporation. This test, taken generally from the proposed §385 regulations with respect to hybrid instruments not held proportionally to shareholders, would be applied in lieu of any application of the §385 regulations as such.

PASSIVE INVESTMENT INCOME LIMITATION

Under present law, a Subchapter S election is terminated if twenty percent or more of the corporation's gross receipts consists of passive investment income. The termination of the election applies for the year in which the passive income reaches this level and for all succeeding years of the corporation.

The initial reason for this restriction was to limit the opportunity to incorporate investment activities for the primary purpose of obtaining tax deferral benefits provided by qualified pension, profit sharing and other similar plans. This opportunity, however, was substantially reduced in the Tax Reform Act of 1969 by the imposition of an H.R. 10-type limitation on contributions made for an employee holding more than five percent of the stock of the Subchapter S corporation. Because Subchapter S income is currently taxed to the shareholders, the receipt of passive investment income by a Subchapter S corporation does not subvert the purposes of the personal holding company provisions. The passive investment income limitation has caused a number of inadvertent terminations of elections, as well as a substantial amount of litigation as to what constitutes passive investment income.

In view of the fact that the passive income limitation is no longer necessary and that it causes severe problems in the application of Subchapter S, the Section of Taxation strongly supports the proposed elimination of the twenty percent limitation for corporations which do not have accumulated earnings and profits at the close of the taxable year. This, however, does necessitate special rules for corporations with earnings and profits which seek to elect Subchapter S.

CORPORATIONS WITH EARNINGS AND PROFITS ELECTING SUBCHAPTER S

Such special rules are required because it is not feasible to eliminate the existing passive income limitation, and to provide the other liberalizations contained in this bill, without restricting the opportunity of corporations which have undistributed income (accumulated earnings and profits, or E&P) to utilize Subchapter S. Corporate income is taxed at a proportional rate, not progressive rates, and significantly lower rates apply to the first $100,000 of corporate taxable income each year. In addition, a number of rules affecting individuals do not apply to corporations, and the taxation of corporate income otherwise may be somewhat more favorable than the taxation of individual income. The existing United States income tax system generally contemplates that corporate income will at some stage be taxed to the shareholders individually as a result of dividends, distributions in liquidation, or as gain upon sale of stock. Subchapter S without a passive income limitation would permit shareholders to defer indefinitely, or even ultimately to avoid, this shareholder level tax on undistributed corporate earnings while still enjoying the fruits of the shareholders' capital represented by such undistributed earnings.

If there were no special rules in Subchapter S to deal with these circumstances, the following, for example, could occur -- (1) a Subchapter S election could be made by a corporation with such undistributed earnings; (2) the assets reflected by such earnings could be placed in a diversified portfolio of passive investments; and (3) the shareholders could receive the current income from such passive investments and be taxed only on such current income. The undistributed earnings of prior years, having incurred only the burden of the more favorable corporate tax regime, would not be taxed to the shareholders. As previously stated, the shareholders could thereby enjoy the fruits of the undistributed earnings without incurring the shareholder tax on such undistributed earnings.

H.R. 6055 in its present form would resolve this problem arbitrarily by requiring an existing corporation with E&P which elects Subchapter S to remain subject to the existing passive investment income limitations (the twenty percent rule). We recommend instead a so-called two-track approach. Corporations with E&P making a Subchapter S election would be required to elect either one of two tax regimes. Under one option, the corporation with the consent of its shareholders would elect to report its E&P as income to its shareholders ratably over a five year period. The shareholders would pay a tax at capital gains rates over the five year period (twenty percent of the E&P would be reported in each of the five years). The measurement of gain would be the lesser of the shareholder's share of E&P or an amount equal to the gain that would have been realized if on the date of the Subchapter S election the shareholder had sold at fair market value all of his shares in the corporation. The corporation could then elect Subchapter S and be governed by all of the new rules, as provided in H.R. 6055.

In addition, since the E&P of the corporation would become taxable to the shareholders by reason of such election, a capital gains tax on corporate income under proposed Code §1374 as contained in H.R. 6055 would not be required. The corporation in such a case would be treated in the same manner as a corporation that had elected Subchapter S from its inception. The taxation of the E&P to the shareholders should, as hereinafter stated, permit corporations electing this treatment to be taxed under rules similar to the partnership rules with respect to the distribution of property in-kind. A technical explanation of this proposal, along with suggested bailout prevention rules, is being included in the written technical changes that the Section of Taxation is submitting.

For those corporations with E&P that elect Subchapter S but do not elect that the E&P be taxed to the shareholders, the rules for the "second track" should nonetheless be developed so as to be as easy to administer as possible. Every attempt must also be made in such rules to avoid traps for unsophisticated taxpayers. We recommend that the corporations not electing taxation of their E&P to shareholders be entitled to all of the benefits of the changes proposed in H.R. 6055 except those provisions which require special rules to deal with the existence of undistributed corporate earnings. Specifically, we recommend that different rules apply to corporations that exceed a threshold level of passive investment income, to distributions in excess of current earnings, to property distributions, and with respect to proposed Code §1374 relating to certain capital gains.

In developing the threshold level of passive investment income, we recommend that the "personal holding company income" rules of §543 of the Code be applied as the standard. These rules are well-established and are familiar to tax advisers and even to many small businessmen. We recommend, however, that certain modificiations be made as to certain types of rental and interest income that are clearly "active" income to certain corporations.

If a corporation in this situation has passive income in excess of the threshold level under our proposed modified personal holding company standard, the Subchapter S election should be terminated. Termination continues to be a particularly harsh result in those situations in which the threshold level of passive income is inadvertently exceeded, however, and as stated below we urge adoption of reasonable provisions to permit correction of inadvertent terminations.

With respect to proposed new Code §1374 imposing a corporate level tax on the Subchapter S corporation with a substantial capital gain, we propose somewhat broader application than H.R. 6055 provides as to a corporation with E&P electing Subchapter S but not electing shareholder taxation of the E&P. It should apply if the election has not been in effect for at least five years. It should also apply to a sale made during a five year period following the Subchapter S election to the extent principal is paid during the five year period.

FOREIGN SOURCE INCOME

H.R. 6055 would retain the restriction whereby a Subchapter S election is terminated if the corporation has foreign source income. This restriction is unnecessary and should be repealed.

ELECTION, REVOCATION, AND TERMINATION

The Section of Taxation supports the provisions of H.R. 6055 that a timely Subchapter S election for the current taxable year will be effective only if the corporation meets all qualifications for election from the beginning of the taxable year through the date of the election and if the shareholders during the entire period consent to the election.

The Section of Taxation also supports elimination of the requirement that a new shareholder may terminate the election by filing an affirmative refusal to consent to it. A new shareholder who knows he is acquiring stock of a Subchapter S corporation should not have power to terminate that election; it gives such a person undue leverage on the other shareholders and can easily be abused. In addition, and for similar reasons, we support elimination of the present rule requiring all of the shareholders to revoke the election. The existing rule is too restrictive; minority shareholders should not be able to prevent a revocation sought by most shareholders. H.R. 6055 rectifies both of these problems by appropriate means, and we strongly support these new provisions.

Under present law, termination of a Subchapter S election applies retroactively to the first day of the taxable year in which a terminating event occurs (e.g., exceeding maximum allowable number of shareholders or creation of a second class of stock). The Section of Taxation supports the change proposed in H.R. 6055 whereby an event occuring during the taxable year (except excessive passive income in certain cases) causing a corporation to fail to meet the definition of a Subchapter S corporation would terminate the election only as of the day of the event causing the failure. The proposed rule would reduce the opportunity under present law for year-end manipulation by which shareholders can intentionally create disqualifying events to terminate the election retroactively to the first day of the year.

Under present law, terminations of elections occur even where the existence of the terminating event is entirely inadvertent. The results to the shareholders may be very harsh and may be unnecessary and inappropriate in the circumstances. An example would be sudden and unexpected business reversals which cause passive income to exceed the twenty percent level. There is a special rule in existing law to deal with this situation, but it is so narrowly drawn as to be inadequate in many cases. H.R. 6055 would give discretion to the Internal Revenue Service to allow a corporation to continue as a Subchapter S corporation notwithstanding an inadvertent termination. We strongly support this provision and suggest that the Service be encouraged to exercise the discretion fully and reasonably to avoid hardships.

OPERATING RULES

H.R. 6055 would provide significant improvements in the "operating rules" for qualifying Subchapter S corporations. The Subcommittee has requested comment on the question whether the bill simplifies the determination of income. We believe that it does. Under present law, taxable income of a Subchapter S corporation is taxed at the shareholder level whether distributed or not, with net long-term gain being the only item retaining its character at the shareholder level. H.R. 6055 preserves the character of items of income, deduction, loss, and credit to the shareholder in the same general manner as they pass through from partnerships. This is a much improved approach which the Section of Taxation has strongly endorsed for many years.

The Section supports revision of present law which allocates undistributed taxable income to shareholders only as of the end of the year while allocating net operating loss on a per-day basis. H.R. 6055 would require that all items be allocated on a per-share, per-day, basis to anyone owning stock at any time during the year. This provides a more accurate allocation of income and prevents the abuses which can occur under current law with respect to shifting of income.

The Section supports the provisions of H.R. 6055 which would allow a shareholder to carry forward his share of the loss of a Subchapter S corporation to the extent that his basis is exceeded. This conforms to the partnership rule of permitting the loss to be carried over and deducted if and when the basis is restored.

Under existing law, adoption of a corporate fiscal year can be utilized under Subchapter S to defer the payment of tax on the first year's income from the business for as much as almost one full year. H.R. 6055 would conform the Subchapter S result to the partnership treatment and require adoption of a calendar taxable year unless the corporation can show a business purpose for another accounting period. The Section of Taxation endorses the adoption of these new taxable year provisions.

H.R. 6055 also would make substantial modifications in the taxation of distributions from a Subchapter S corporation. Under present law, the taxation of such distributions is governed by complex provisions with respect to "undistributed taxable income" and "previously taxed income". While shareholders are taxed on current income, distributions of income previously taxed are not taxed a second time. Special rules also apply to distributions of property in-kind.

With respect to property distributions, the Section of Taxation favors the distribution rule in proposed Code §1368 in H.R. 6055 for distributions from corporations which have E&P and which have not elected shareholder taxation of such E&P. The Section believes, however, that long-term capital gain property distributions from corporations which have elected shareholder taxation of their E&P, or corporations which have always been Subchapter S corporations, should be taxed under rules similar to the partnership rules for the taxation of distributions of such property.

The changes proposed in H.R. 6055 as to distributions and basis, modified as we have suggested, would provide a much more logical and simplified method of taxing the income of a Subchapter S shareholder.

QUALIFIED PLANS AND FRINGE BENEFITS

The Section strongly opposes the provisions of H.R. 6055 which would impose upon Subchapter S corporations the partnership (self-employed) rules for qualified pension and profit-sharing plan and similar purposes, and for "employee fringe benefit purposes". For these purposes, a person owning two percent or more of the corporate stock would be treated as a partner, and a ten percent owner would be treated as an owner-employee. This restrictive treatment is unfair and unnecessary. It would effectively deny the benefits of Subchapter S to many small businesses.

Shareholder-employees of a Subchapter S corporation should be treated for purposes of the qualified plan and fringe benefit provisions in the same manner as shareholder-employees of any other closely-held corporation. There is nothing in the nature of Subchapter S that calls for different treatment. Shareholder-employees of a Subchapter S corporation must satisfy the reasonable compensation test for qualified plan purposes to the same extent as shareholder-employees of any other corporation.

The correct treatment in these areas is equality of treatment of all persons who have personal service earnings, whether self-employed or corporate employees. H.R. 6410 introduced recently by Congressman Rangel moves importantly in this direction, though it is incomplete in some important respects and creates new discriminations in other respects. The Section of Taxation testified on behalf of the entire American Bar Association on H.R. 6410 on June 10, 1982, and we urge this Subcommittee to consider such testimony in evaluating proposed Code §1372 in H.R. 6055. We also urge the Subcommittee to consider the testimony of the Treasury Department on H.R. 6410, which generally supports the principle of equality of treatment of all persons with personal service earnings and in many respects parallels the testimony of the American Bar Association.

CONCLUSION

The Section of Taxation enthusiastically supports the enactment of H.R. 6055 with certain modifications. It is a product of a collegial process to simplify the Internal Revenue

Code in specific areas which affect large numbers of taxpayers. This collegial process involving the Congressional staffs, the Treasury Department, the Section of Taxation of the American Bar Association, and the American Institute of Certified Public Accountants has focused upon many important areas. The Installment Sales Revision Act of 1980 was a product of that process and has proved to be a great success. This Subchapter S bill, H.R. 6055, is the next step in that process, and we feel certain that with the modifications we have suggested, it will be an even greater success.

Thus, H.R. 6055 will greatly simplify taxation for a very large segment of small business. This Subcommittee should favorably report H.R. 6055 at the earliest possible time. Its approval will be an important signal to the participants in the collegial process to continue with their vital work. There is more on the way; we urge this Subcommittee to join us in supporting simplification of the tax system in ways that realistically can be accomplished.

Chairman STARK. Mr. Diss, if you like, you may proceed.

STATEMENT OF WILLIAM T. DISS, CHAIRMAN, SMALL BUSINESS TAXATION SUBCOMMITTEE, FEDERAL TAX DIVISION, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

Mr. DISS. Yes, Mr. Chairman.

It is a pleasure to represent the American Institute of CPA's. I appear in my capacity as chairman of the small business taxation subcommittee. We support the provisions of H.R. 6055, again with certain modifications, provided that the mandatory toll charge provision is not adopted.

Specifically, we support the enlargement of the numeric limit on shareholders, the requirement for revocation by majority of shares, the elimination of the catch-22 result for a late-filed election, the use of the per share/per day formula to allocate both profits and losses, and the entity level administration and audit.

We do have some reservations on the injection of the cash basis rule for expenses accrued to 2 percent or larger shareholders as well as the repeal of fringe benefits for these shareholders, some aspects of the fiscal year conformity provision, the constructive gain on in-kind property distributions, the split-year subchapter S to subchapter C reporting, and continuation of the 80-percent foreign receipts limitation.

In addition, we believe there should be consideration of a more comprehensive provision for cure of subchapter S disqualification, shift of all investment credit recaptured to the corporate level and a specific provision for stock owned by a life tenant.

It appears there are still some difficulties in the area of community property stock ownership. We believe there should be a congressional declaration of policy on the coordination between the section 385 corporation and the subchapter S rules.

In regard to specific issues posed by the congressional leadership who introduced this bill, we have considered two criticisms by commentators to the repeal of the passive receipts test. One is that an outlet to the personal holding company provisions is afforded by such repeal and the second is that there should be a toll charge constructive liquidation or dividend imposed upon the conversion of corporation from subchapter C to subchapter S status.

We believe that imposition of a toll charge will create an unnecessary complication in the tax law, but if the Congress believes that the repeal of the passive receipts limitation and use of subchapter S by an investment company requires further restrictions, we would support a compromise along the lines described by Mr. Nolan that would impose a disqualification rule for a corporation that was otherwise a personal holding company, unless that corporation elected a toll charge for its accumulated earnings and profits at the time of its subchapter S election.

This toll charge would be taxed along the manner described by Mr. Nolan, using capital gain rates over a 5-year period.

In regard to the one class of stock issue, also posed by the leadership, we do support the provision that would allow variation in the voting rights for one class of stock and agree with Mr. Glickman that the allowance of two classes of stock again provides an unnecessary complication in the allocation of profit and loss to shareholders.

We do not believe that the section 385 rules should be applied to subchapter S. Our previous testimony opposed these regulations, and we see no reason to inject this complication into the subchapter S area.

With regard to fringe benefits, we would support the approach that appeared in the joint committee print of April 30, 1980, that is to continue fringe benefits but for corporations that met the old law or existing law 20-percent passive receipts limitation, in order to prevent fringe benefits for an investment company.

With regard to the fiscal year conformity we would also prefer that the approach in the joint committee print be used. That is that a corporation be allowed to report on a natural business year or a fiscal year that ended September 30 or after within the calendar year.

We believe that imposition of a calendar year rule is going to create practitioner workload problems and further resort to extensions for filing individual returns. In other words, more pressure on our return compliance system.

We support in particular the solutions in this legislation to the three principal problems under existing law, that is to repeal the current earnings and profits rule on earnings and profits in excess of taxable income. We believe this is not being enforced by the Internal Revenue Service now and it would be preferable to repeal it altogether, particularly with the earnings and profits now created under the ACIS depreciation earnings and profit rule.

Second, the passive receipts repeal and, third, the ability to carry over unused losses at shareholder level.

I mentioned we have reservations in certain areas. One is on the split year reporting subchapter S to subchapter C. We note, Mr. Chairman, that this is going to complicate considerably the accounting and reporting for corporations.

In the area of the cash method for expenses to shareholders, we believe that if this is imposed for subchapter S companies, that the same ruling should be applied to partnerships, or in the alternative, that the partnership rule will be applied to accelerate the reporting of the income item by the particular shareholder involved.

The remainder of our testimony appears in the written comments, and we would welcome the opportunity to comment further on the points raised by Secretary Glickman this morning.

Chairman STARK. Thank you, Mr. Diss. I appreciate that.

[The prepared statement follows:]

STATEMENT OF WILLIAM T. DISS, CHAIRMAN, SMALL BUSINESS TAXATION SUBCOMMITTEE, FEDERAL TAX DIVISION, THE AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

The AICPA Tax Division welcomes this opportunity to comment on H.R. 6055 the Subchapter S Revision Act of 1982. This legislation largely reflects the April 30, 1982 Joint Committee print containing the "Staff Recommendations for simplification of Tax Rules Relating to Subchapter S Corporations," prepared by the Staff of the Joint Committee on Taxation for the use of the House Ways and Means Committee and the Senate Finance Committee.

This Joint Committee print, as does the pending legislation, reflects the bi-partisan, non-controversial efforts of the staffs of the House Ways and Means Committee, Senate Finance Committee, and the Treasury to simplify and improve the tax laws, as well as input from the AICPA Tax Division and the American Bar Association Federal Tax Section.

The legislation is the second in a series of "simplification" measures initiated by these committee staffs and Treasury, with advice from the professional tax organizations, and is similar to the 1980 Installment Sales Revision Act in this regard. In general, the AICPA recommends that the legislation be conformed, as nearly as possible, to the Joint Committee print.

Comments appear below on the issues referred to by the Congressional leadership and appearing in the April 1, 1982 Congressional Record.

Summary

The American Institute of Certified Public Accountants Tax Division ("AICPA") supports in particular the three major improvements appearing in the legislation -- repeal of the passive receipts test, elimination of election period earnings and profits, and provision for carry over for unused shareholder loss allocations. In addition the AICPA supports other improvements such as:

- ° Enlargement of the shareholder numeric limit
- ° Requirement of majority in shares for revocation of the election
- ° Relaxation of the old law previously taxed income lock-in rules
- ° Elimination of the "Catch 22" result for a late-filed election
- ° Unification of the per share/per day profit and loss allocation to shareholder computation
- ° Provision for tax administration and settlement related to the corporate entity.

The AICPA has certain reservations regarding the following:

- ° Cash basis rule for expenses paid to 2% or larger shareholders (added to the legislation shortly before its introduction)
- ° Repeal in 1985 of fringe benefits for these stockholders
- ° Fiscal year conformity
- ° Constructive gain on in-kind property distributions
- ° Split year Subchapter S to Subchapter C reporting
- ° Continuation of the 80% foreign receipts limitation.

Consideration should be given to further refinements such as a more comprehensive provision for cure of Subchapter S disqualifications; imposition of all investment recapture at corporate level; and a specific provision for stock owned by a life tenant, or in any form of life estate or usufruct. A comprehensive solution should be sought for all stock ownerships affected by community property rules. Finally a congressional declaration of policy seems apppropriate regarding the inter-relationship between the §385 debt and equity interests rules and an electing corporation.

Congressional Leadership Issues

Converting Corporation

Subsequent to the issuance by the Joint Committee on Taxation of its April 30, 1980 bi-partisan, professional consensus report, the ability of a regular corporation reporting under Subchapter C, to elect Subchapter S treatment was challenged by two commentators. Continuation of the 20% gross receipts limitation for a corporation with accumulated earnings and profits was intended to serve as a provisional solution to their concerns.

The first critic noted that elimination of the passive receipts test permitted a private or family investment company an outlet from the usual personal holding company restrictions.

The AICPA believes that the concern of personal holding company avoidance is not well taken. The family investment company can arrange for most of the gross income of the corporation to be dividends subject to at least the 85% dividends received deduction, largely eliminating the double taxation of the family's earnings. Family financial or estate planning and corporate estate planning often are better accomplished by use of a personal holding company ("PHC") inasmuch as recapitalization plans permitting the older generation in the family to hold preferred stock are permitted for a PHC.

However the Congress may conclude that a new law "S corporation" could avoid the detailed restrictions imposed when regulated investment companies were authorized to hold portfolios concentrated in municipal bonds. A personal holding company is unable to distribute dividends to its shareholders, sourced upon municipal bond interest income, without having such distributions treated as taxable dividends. Accordingly Congress might wish to continue the concept of election year current (excess) earnings and profits as to municipal bond interest income only, with a sourcing priority for actual dividends from this income, then require that such distributions be treated as taxable dividends by the recipient stockholders.

The second critic has urged that the election be treated as a constructive liquidation, deemed dividend, or combination of both. He argues that the conversion from "C" to "S" status should be treated as if the corporation had liquidated and the former stockholders joined together as partners as an investment company.

The AICPA believes this proposal is unwise, and represents an unacceptable complication in the income tax law. More important, we do not perceive any tax abuse potential for converting corporations. The earnings and profits accumulated to the election date remain in "corporate solution" and any distributions therefrom to the stockholders are taxed as ordinary dividend income under existing law, as well as the proposed legislation. Any shareholder withdrawals that might occur during the election period can only relate to "S year" earnings, and not to the accumulated earnings and profits.

Furthermore we see no policy difficulty in permitting a family corporation to report either under Subchapter S, or as a personal holding company. The Congress might well conclude that it is desirable to permit the continuation of closely held corporations with investment portfolios rather than fostering continued concentration of financial wealth in larger corporations, through mergers and acquisitions.

However if Congress concludes that conversion from "C" to "S" status with continued corporate existence and activities related to investments, rather than an active trade or business, should be restricted, we reluctantly recommend a different solution, viz. that a corporation otherwise subject to the PHC rules because of its closely-held stock and more than 60% of its adjusted ordinary gross income derived from passive investment sources, be ineligible to elect the new law "S corporation" status, unless a "toll charge" on accumulated earnings and profits is elected by the corporation.

This compromise has the merit of permitting small corporations and their tax advisers to rely upon well settled current PHC rules, which include corrective planning provisions. If essential, this compromise can be coupled with the possible continuation of the current earnings and profits rules, described above, for municipal bond interest income.

In lieu of the compromise described above for ineligibility of a PHC to elect "S corporation" status we suggest as a partial solution to the present law difficulties arising from the passive receipts limitation, a revised definition to treat as active receipts, i.e. non-disqualifying income the following:

- All rents
- Interest received by a corporation which qualifies for the finance company exceptions to personal holding company status
- Interest received by a personal property dealer on notes and accounts taken upon the sale of the dealer's inventory.

Other Issues

The AICPA believes that continuation of the current restriction of one class of outstanding stock is desirable. In general, allowance of two classes of outstanding stock would create undesirable complications in the allocation to shareholders of the corporations's earnings and losses. However we do not support provisions of the legislation that permit one class of stock with variation in voting rights.

The "thin capital" doctrine should not be re-imposed on electing corporations. The Congress is aware that the courts have overwhelmingly concluded that this doctrine should not be applied to create a second class of disqualifying stock. Furthermore even a cursory review of the regulations re-proposed under §385, now postponed again, suggests that an electing "S corporation" should not be burdened with the complications shortly to be visited upon the "thin corporation" doctrine. Indeed we believe the Internal Revenue Service would be well advised to exclude from these proposed regulations instruments issued by an "S corporation" during an electing year.

We believe that the continuation of the 80% foreign receipts limitation is unnecessary. The limitation appears to coordinate with §861 (a)(2) which provides foreign source treatment for dividends by a domestic corporation which realizes more than 80% of its gross income from foreign sources. Inasmuch as the pending legislation permits a flow-through of the foreign tax credit to an electing corporation's shareholders, we believe this particular limitation no longer serves its original purpose, and should be repealed.

In regard to fringe benefits, we note that the Joint Committee print would have permitted continuation of these benefits for stockholders of an electing corporation which satisfied the 20% passive receipts test. Another possibility would be to repeal fringe benefits only for a personal holding company. We understand that this limitation was added to the original 1958 legislation in order to prevent an investor from incorporating his portfolio, then establishing employee retirement and fringe benefit plans. Subsequent amendments to Subchapter S have permitted retirement plans subject generally to the proprietorship and partnership plan contribution limitations.

There remains the disparity between an electing corporation and a partnership for fringe benefits but the AICPA does not support this means of eliminating the disparity. We observe, for example, that one difficulty the small business firm faces is the inability to afford the same sophisticated employee benefit package that large corporations offer their executives. Instead of this step backward, Congress should consider extension of fringe benefits to partnerships and proprietorship.

The AICPA had suggested that the fiscal year conformity rule be applied only for a corporation which would otherwise be a PHC, or possibly not a largely operating company within the meaning of §1244 small business stock regulations. The purpose was to avoid an artificial deferral of investment-type income by a corporation newly eligible to elect. An existing operating company on a fiscal year should not involve the same policy feature. We now recommend that a fiscal year ending on September 30 or later in the calendar year be permitted, as provided in the Joint Committee print to accomodate return preparer workloads and reduce the number of individual return extension requests.

Existing Problems and Solutions

The AICPA notes the following problems under existing law and supports the solutions, as annotated to the pending legislation.

1. Current earnings and profits (Subchapter S election year earnings and profits in excess of taxable income or "CEP") §1371 (c).
   - ° CEP from life insurance proceeds and from depreciation differences caused by §312 (k).
   - ° Shareholder taxation for dividends in property, or cash dividends exceeding taxable income.
2. Passive receipts limitation — §1362 (d)(3)
   - ° Fine distinctions between rents and occupancy charges.
   - ° Unavailability of Subchapter S to real estate or finance companies.
   - ° Inadequate safe harbor for passive receipts by a start-up company.
3. Wastage of unused loss allocations to shareholders (in excess of stock and loan bases) — §1364 (d)(2).
4. Unintended income upon repayment of reduced basis stockholder loans — §1367 (b)(2)(B).
5. PTI lock-in after a Subchapter S termination from disqualification — §1377 (b).
6. UTI allocation where mid-year stock sale, and uncertainty as to full year's earnings — §1377 (a).
7. Acceleration of shareholder income for a fiscal year corporation, upon the payment of an "advance" dividend — §1377 (a).
8. Untimely (late) election for current year treated as too early for succeeding taxable year — §1362 (b)(2).

9. Stock redemptions and partial liquidations do not reduce UTI or CEP -- §1368 (e)(1)(B).

10. Fragmented return examination and settlement -- §1375.

However we note that a number of problems under existing law have not been resolved in the pending legislation. We recommend that Congress address these problems in the pending legislation or if this is impolitic, then for a supplemental bill in the next session. Items the AICPA particularly recommends for attention include the following:

1. Pre-date of death UTI under existing law does not qualify as income in respect of a decedent. We believe the same unavailability of §691 deduction applies to the accumulated adjustments account balance incorporated in the pending legislation. The undistributed earnings allocated to the shareholder, at least for the year of death, should be treated as income in respect of a decedent inasmuch as such earnings are taxed both for Federal estate and Federal income tax purposes.

2. The distribution rules in new §1368 should be coordinated with the post-termination transition period rules of new §1377 (b) to permit distributions from the accumulated adjustments account within the transition period.

3. Provision should be made in new §1368 to reduce accumulated earnings and profits for distributions sourced thereon and made during the calendar month of a §333 liquidation.

4. A comprehensive solution to community property stock ownership should be provided, to treat such stock as owned by one, eligible stockholder for all purposes of Subchapter S.

Doubtful Policy Decisions

The AICPA acquiesced in certain policy decisions, in order to achieve the consensus reflected in the Joint Committee print. However if the Congress decides to depart in significant respects, e.g., by inserting provisions related to a "converting corporation" from this Joint Committee print we note certain of our reservations related to the following policy resolutions incorporated in the print and in the pending legislation:

1. Split-year Subchapter S and Subchapter C reporting. We had recommended that a rule, similar to the pending legislation for revocation be applied, i.e., depending upon the timing of the disqualification event, the termination be effective either on the first day of that year, or the first day

of the succeeding year. Imposition of the split-year reporting is a considerable complication for the corporation and its shareholders, including the dual computations of income under the daily proration and the cut-off methods, annualization of the short "C year," etc., and permits manipulation by staging the disqualifying termination event.

2. Cash method for expenses to shareholders. As previously noted this provision was not in the Joint Committee print but was added to the pending legislation shortly before its introduction. This limitation complicates the accounting for a corporation that has numerous employees owning at least 2% of the outstanding stock, and penalizes all shareholders by increasing their net reportable incomes. Congress should consider whether this complication is necessary; if it is, the rule should be extended to §707 (a) payments made by a partnership to a partner in a capacity other than as a partner, or by accelerating the particular shareholder's reporting similar to the §706 (a) timing for a §707 (c) guaranteed payment.

3. Disqualification cures. If the passive receipts limitation is continued in the law, at whatever level, consideration should be given to a more comprehensive disqualification cure, either entailing taxable dividend distributions to the shareholders, or a corporate level tax on the excess passive investment receipts. Such curative provisions are consistent with the inadvertent termination relief included in the pending legislation.

4. Constructive sale on distribution of appreciated property. We acknowledge the need for an anti-bailout provision but had previously recommended imposition of a carryover basis rule for distribution of appreciated property to a shareholder. This would require taxation of the unrealized gain upon resale by the stockholder.

5. Investment credit recapture. A considerable simplification could be achieved if the corporation is made responsible whether reporting as a "C corporation" or a "S corporation" for investment credit utilized by the corporation at corporate level for any year, or by shareholders for any election year. The corporation can maintain the records in a central location to facilitate the identification of property which has been early disposed or for which there has been an early cessation.

As explained above, however, the AICPA is prepared to support the pending legislation as introduced, provided that substantial alterations are not inserted to generally mandate shareholder taxation of undistributed accumulated earnings and profits of a "converting corporation."

* * *

Thank you for this opportunity to submit the AICPA's comments on H.R. 6055.

Chairman **Stark**. Mr. Shaw.

STATEMENT OF RICHARD A. SHAW, CHAIRMAN, TAX SECTION, CALIFORNIA STATE BAR ASSOCIATION

Mr. **Shaw**. Good morning, Mr. Chairman. I am Dick Shaw, chairman of the Taxation Section of the State Bar of California. I have in the past also served as chairman of the California Subcommittee on Subchapter S and as chairman and adviser of the American Bar Association Committee on Subchapter S.

The taxation section of the State Bar of California is pleased to recommend adoption of H.R. 6055. We believe that the bill represents a positive, comprehensive simplification of a complex law which is long overdue. In my statement I have set forth in detail a number of our concerns and comments. Let me briefly summarize some of our conclusions.

Regarding the section 385 regulations, the taxation section believes that the application of the regulations on section 385 is not appropriate for subchapter. The courts have, through a number of years, reached the unanimous conclusion that the thin corporation doctrine is not a practical or appropriate test for subchapter S corporations.

Since all of the income of the corporation is taxed when earned by the corporation, there is really very little incentive for tax avoidance. In addition, when subchapter S was enacted, Congress recognized the significance of shareholder loans by permitting losses in small business corporations to be passed through and used as adjustments to debts advanced by those shareholders. The statute very clearly recognizes the importance of these advancements.

In addition, we believe that the new provisions in the act take care of any areas of potential abuse. The proposal in section 1366(e), whereby the Secretary will be permitted to shift income among members of a family group to more clearly reflect the value of services rendered or capital advanced, will enable the Government to properly characterize income where there is a potential abuse.

In addition, the contemplated insertion of the 267 rules concerning the relationship between deduction at the corporate level and income at the shareholder level are being imposed in subchapter S. We believe that those problems will be solved by those sections.

Let me emphasize one particular point with respect to 385. Subchapter S is aimed for and designed for the small business corporation. I recently looked at the new CCH publication setting forth the proposed 385 regulations. Those regulations are 52 pages long. I do not believe that it is appropriate for the small mom-and-pop grocery store to have to become familiar with the intricate details of those 52 pages. It is not realistic.

The second area that I want to talk about is the passive investment income test. If we look back historically, we will note that back in 1969 the Treasury Department supported the removal of the passive investment income tax in its entirety, and that in 1980 the Joint Committee on Taxation proposal requested the removal of the passive investment income test.

We of the California tax section are very pleased that passive investment income test, the 20-percent gross receipts test, is being removed for corporations without accumulated earnings and profits.

Realistically, we do not believe that there is a significant problem that warrants its continuation in accumulated earnings and profits situations.

We do recognize that there is a potential opportunity for abuse. If it should be the position of Congress that some provision should be included to take care of the potential situation where a C corporation has accumulated earnings and profits, sells the active business, converts it to investment activities, and then continues on, then we would support generally the American Bar Association position which would propose that there be a personal holding company test in lieu of a passive investment income test, and which would recognize that in the event a subchapter S election is made, that the taxpayer at least be given the opportunity in an option, to accelerate the gain on the accumulated earnings.

It is the position of the California taxation section, nonetheless, that probably this is a step up in basis at death problem rather than a subchapter S problem and, therefore the passive investment income test could very easily be removed and this dealt with in another way.

We have a few other areas that I would like to summarize very quickly. The California taxation section disapproves those sections of the bill which would reduce the qualified retirement benefits and fringe benefits of employee shareholders by characterizing those employees as partners. The act fails to recognize the true employer-employee relationship which exists in subchapter S corporations. We believe, instead, Congress should be encouraging privately funded retirement plans for closely held businesses rather than imposing additional restrictions.

In addition, should it be necessary to continue some sort of restriction, we believe the 2-percent partnership rule is too low. The Joint Committee on Taxation recommendations in 1980 had suggested 5 percent. We would recommend that as a minimum.

In addition, we are concerned that the statute does not define fringe benefits. It says that we are going to treat these shareholder employees as partners for the purpose of certain fringe benefits, but does not define them. We would recommend that if it is necessary to include a provision on fringe benefits, we at least have guidelines as to what Congress believes they are. It is really truly in the eyes of the beholder as to what are fringe benefits.

We endorse the principle that there ought to be a tax audit at the corporate level, but suggest that it be deferred until the potential administrative problems have been resolved.

We endorse the proposition that there should be generally a calendar tax year for subchapter S corporations, but oppose the proposition that present subchapter S corporations should be required to go to a calendar year when there is a 50-percent chance in ownership. We believe this is unnecessary, and that the new bill can act very effectively by dealing with prospective corporations.

Finally, recognizing a specific problem of California, I would direct the committee's attention to page 9 of my statement, and suggest that they evaluate it in detail later. We have a problem in

California where the Department of Corporations reserves the right to condition the issuance of stock on services by placing a restriction upon dividend distributions and liquidation preferences for those shareholders.

This creates a significant problem. We believe that it can be resolved easily in the statute by simply requiring that if there are governmental restrictions, the shareholders be permitted to use subchapter S provided that they agree to treat the distributions and items as if those State-imposed restrictions did not apply.

In conclusion, it is the belief of the California tax section that the act is a major improvement in Federal taxation. It will substantially benefit subchapter S, and will be of material benefit to small businesses.

Thank you.

[The prepared statement follows:]

STATEMENT OF RICHARD A. SHAW, CHAIRMAN, TAXATION SECTION OF THE STATE BAR OF CALIFORNIA

INTRODUCTION

My name is Richard A. Shaw. I am the Chairman of the Taxation Section of the State Bar of California. As such, I am appearing on behalf of the 2,500 members of our Tax Section. In my presentation today, the views which I express represent only the views of the Taxation Section, since there has not been an opportunity for review or approval by the Board of Governors of the California State Bar.

In my individual capacity, I have been substantially involved with Subchapter S of the Internal Revenue Code for approximately 20 years and have served as Chairman and Special Advisor of the American Bar Association Tax Section Committee on Subchapter S and also as Chairman of the California Tax Section Subcommittee on Subchapter S.

RECOMMENDATION

The California Tax Section is pleased to recommend the prompt enactment of HR-6055, the Subchapter S Revision Act of 1982. It represents a positive comprehensive simplification of a complex area of tax law which is long overdue.

When Subchapter S was created in 1958, it was done so with the intent that taxpayers should be able to practice in a corporate form without having income taxed first at the corporate level and then again upon distribution to the shareholders. Although earlier proposals in 1954 had designed a concept to tax the shareholders as partners, the Subchapter S law created in 1958 was designed to tax all current taxable income as dividends to the shareholders whether distributed or retained at the corporate level. Only capital gains are passed through to shareholders. In addition, a system was formulated to permit subsequent distributions of previously taxed income without taxation to the shareholder at the time of distribution. In order to keep administration simple and to prevent tax abuse, extensive controls were established on eligibility, on the nature of permitted income, on operations and on distributions.

Even though the initial objective was commendable, it has been evident for the last 24 years that the complex formulas to integrate the various segments of the new system and the many safeguards incorporated to prevent abuse have caused Subchapter S to be recognized as one of the foremost traps for the unwary in the Internal Revenue Code. Although substantially improved through the years, the eligibility conditions have been a constant concern and cause for frequent inadvertent terminations. Although simplifying the tax system, in part, by characterizing the corporate income as dividends, the statutes developed a complex maze of operational priorities and restrictions which must be traversed before shareholders can determine whether to treat subsequent cash or property distributions as taxable dividend distributions from current earnings and profits or from accumulated earnings and profits, or as nontaxable distributions of previously taxed income or possibly as returns of capital or distributions subject to capital gain treatment. The complexities of the system and the risk of error or inadvertent termination has been such that many practitioners have encouraged taxpayers to avoid Subchapter S unless prepared to undertake the costs and efforts involved with constant supervision. As a result, Subchapter S has never obtained its full potential for offering small groups of individuals the opportunity to select the corporate form of business while retaining a simple single level tax structure.

The proposed Subchapter S Revision Act of 1982 offers substantial revisions which go a long way toward eliminating inadvertent hardships and assists a great deal towards tax simplification.

In evaluating HR-6055, we recognize that the proposed bill has had the unique benefit of substantial staff input from governmental agencies and from private tax practitioners which spans more than 15 years. As a result of the extensive cross fertilization of information and the incorporation of many suggestions previously made by the private sector, HR-6055 already contains many of the features and refinements which we believe are necessary for a more effective Subchapter S election and for good income tax simplification. In general, it is the belief of the California Taxation Section that the bill will make the administration and enforcement of Subchapter S more efficient and more certain for both the taxpayer and the government.

For the balance of the presentation, I would like to direct my attention to selected aspects of the bill. Comments will be brief, recognizing that more substantive detail can be furnished in subsequent technical comments.

GENERAL DISCUSSION

1. NUMBER OF SHAREHOLDERS

Since Subchapter S by its nature is most suitable for a small number of shareholders, it has been the belief of many members of the Taxation Section that a shareholder limit is arbitrary and unnecessary. To the extent that some number is deemed necessary, the Section favors the proposed limit at 35 shareholders. This will minimize the risk of inadvertent termination resulting from the growth in the number of shareholders caused by sales, gifts death or other estate planning.

2. STOCK OF VOTING RIGHTS

The Section endorses the recommendation in Section 1361(c)(4) that differences in voting rights should be permitted among shares of common stock. Differences in voting rights among Subchapter S shareholders has no negative impact on the tax consequences, does not effect administration and would not cause any tax abuses. In addition, statutory recognition would be consistent with case law which recognizes that private proxies and voting agreements do not cause a second class of stock. Parker Oil Company, Inc., 58 T.C. 985 (1972).

3. DEBT AS A SECOND CLASS OF STOCK--SECTION 385

Although the present bill makes no reference to Section 385, inquiries have been raised concerning the appropriateness of established guidelines in Subchapter S for determining when debt should be treated as equity. It is the position of the Tax Section that Section 385 Regulations are not appropriate for Subchapter S. In a series of cases in the 1960s and early 1970s, culminating in James L. Stinnett, Jr., 54 T.C. 221 (1970), Amory Cotton Oil Co. v. U.S., 468 F.2d 1046 (5th Cir. 1972) Shores Realty Co., Inc. v. U.S., 468 F.2d 572 (5th Cir. 1952) and Portage Plastics, Inc. v. U.S., 468 F.2d 632 (7th Cir. 1973), it has been established that the thin corporation doctrine testing the ratio of debt to equity in a corporation is not appropriate for Subchapter S corporations. Since all income is taxed to shareholders when earned by the corporation there is little tax avoidance motivation for characterizing later distributions as return of loaned principal. While a payment of interest to a shareholder-lender by a C corporation is deductible, and payment as a dividend is not deductible, the issue is not material to a Subchapter S corporation. Likewise, the Courts recognize that Congress anticipated significant shareholder advances to the corporation by permitting losses to be taken by shareholders to the extent of shareholder loans in present Section 1374.

To the extent that there might be a potential opportunity for shifting any tax consequences, it is believed that new Section 1366(e) will cover the situation. That section will now permit the Secretary to make adjustments between members of the family group to more clearly reflect the value of services or capital furnished to the corporation by family members. In addition, the new provisions will incorporate the principles of Section 267 which would prohibit the corporation from taking a deduction for unpaid expenses and interest unless they are concurrently taken into income by the shareholder.

It has taken the Treasury Department 13 years to draft the present extremely complex proposed debt-equity regulations under Section 385. The regulations would breed uncertainty and confusion in an arena where they do not fit. The potential problems can be seen quickly by examining the proposed §385 regulations. The Commerce Clearing House publication setting forth the proposed regulations is 52 pages long. It took the Treasury Department 43 pages to define its interpretations as to when instruments represent equity or debt and another 9 pages to explain what it meant in drafting the proposed regulations. We do not believe it is realistic to expect the small mom-and-pop grocery store owners to become familiar with the intricate details of those 52 pages. The consequence of failure should mom or pop be wrong in guessing where their "debt" fits under the regulations, would be the destruction of their Subchapter S election. Instead of making Subchapter S more attractive, the adoption of the proposed §385 regulations to Subchapter S would drive many small businessmen away because of their unwillingness to bear the risks in second guessing the extremely complex guidelines in the regulations.

In addition to the definitional problems created by the regulations, we prefer not to further styme the efforts of small business in obtaining loans in a modern financing world which constantly tests the creative imagination of financial institutions.

After evaluating these considerations and recognizing the importance of keeping Subchapter S simple, it is our recommendation that Section 385 and its regulations are not suitable for Subchapter S. Since case law has completely settled the thin capitalization issue, we believe that simplification is best served by remaining at the status quo. The Taxation Section recommends that the bill be amended to specifically provide that Section 385 shall not apply to Subchapter S.

4. PASSIVE INVESTMENT INCOME--GENERAL RULE

HR-6055 will eliminate the passive investment test for corporations which do not have accumulated earnings and profits. This is a very positive step forward. The passive investment income test was initially created to prevent passive investors from utilizing Subchapter S corporations to obtain corporate fringe benefits not otherwise obtainable. Since retirement plan benefits are now available to individuals and partnerships, there is general consensus that there is no real need for a passive investment income test for simple Subchapter S corporations.

5. PASSIVE INVESTMENT INCOME - THE ACCUMULATED EARNINGS AND PROFIT LIMITATION

The bill proposes to retain the 20% gross receipts limitation on passive investment income when the electing corporation has accumulated earnings and profits.

Historically, there was an agreement by the Treasury Department in 1969 that it would support the complete elimination of the passive investment income test if the American Bar Association would agree to support the limitations on retirement plan benefits proposed in Section 1379 for Subchapter S. In the Tax Reform Act of 1969, as enacted, the HR-10 - Keogh type retirement plan limitations were adapted but the passive investment income restriction remained intact. Although the Treasury Department has now reversed its position, the Staff of the Joint Committee on Taxation, in its April 30, 1980 recommendations for comprehensive revision to Subchapter S, continued to support complete elimination of the passive investment income test for all purposes. The California Taxation section believes that the passive investment income test should be eliminated entirely in the interest of simplification.

The sponsors of the bill have raised a potential area of concern where accumulated earnings and profits exist at the time that the Subchapter S election is made. In this one situation, one can postulate the existence of an operating business which has accumulated earnings and profits as a C corporation. The corporation then sells the operating assets, converts the proceeds to passive investments and continues the corporation as a Subchapter S corporation until the death of the shareholder. Upon the death of the shareholder, the successor in interest would have a stepped up basis in the stock and could liquidate the corporation without the accumulated earnings and profits ever having been taxed.

A pure analysis indicates that attention is being directed to the wrong tax issues. The improper tax avoidance, if any, in the hypothetical arises from the step-up in tax basis at death - a result which is sanctioned by the code after several years of re-evaluation and testing with carryover basis concepts in the 1970's.

The existence of accumulated earnings and profits at the time of the election has not been a problem for electing corporations and need not be one under the new system.

Under present law, there is no immediate tax impact when a corporation with accumulated earnings and profits elects Subchapter S. The existing accumulated earnings and profits are generally held in abeyance during the election. Annually, the shareholders are first taxed on current income and are then permitted to make tax free cash distributions of previously taxed income from prior election years. Only then would additional distributions be deemed to be from accumulated earnings and profits. This system has worked effectively for 24 years and shows no signs of abuse.

Even the proposals carry on a similar concept. Upon making the election, the accumulated earnings and profits are frozen. Under the bill, as income and expense items are incurred they will pass through to the shareholders. The shareholders will have an "accumulated adjustments account" pursuant to §1368(e), which accumulates the net income which is passed through to the shareholders. When distributions of cash from the corporation exceed the accumulated amount in the accumulated adjustments account, then any pre-existing accumulated earnings and profits would be taxed to the investors at ordinary income tax rates. The individual shareholders cannot withdraw any of the accumulated earnings without suffering an immediate tax.

This system for taxing accumulated earnings has been fair under present law and would be continued under the new law.

Thus, the real issue is whether it is necessary or proper to single out the Subchapter S corporations with accumulated earnings and profits for special tax restrictions because its shareholders might benefit from an unrelated tax provision providing for a stepped-up basis at death. We do not believe it is necessary or appropriate to selectively use Subchapter S corporations as a means of attacking general perceived wrongs with the stepped-up basis provisions in Section 1014.

If a decision is reached that some restriction should be retained upon passive investment income until accumulated earnings and profits have been distributed or otherwise taxed, we would support the contemplated recommendation of the American Bar Association Tax Section that the taxpayer be given an option to have the accumulated earnings and profits taxed at capital gain rates at the time of the Subchapter S election or thereafter in order to remove the accumulated earnings and profits.

In general terms, the American Bar Association recommends that any electing corporation with accumulated earnings and profits should be given an option to avoid the passive investment income restrictions by electing to have all accumulated earnings and profits taxed to the shareholders at capital gain rates, with the tax being paid in 20% installments over five years. There are special ordinary income recapture rules if the election is terminated during the five year period. We believe the concept has significance independent of the passive investment income issue and might be suitable for adoption even if the passive investment income test is dropped. The option may act as an inducement for many corporations to pay a lower capital gains tax now in order to have the additional flexibility in making distributions in the future. It should act as an effective revenue producing incentive. Accumulated earnings are frequently stored at the corporate level for many years and revenue collections accordingly deferred until later distribution. We recommend that the optional pick up capital gain tax on accumulated earnings be given serious consideration for inclusion in Subchapter S.

Should a test be preserved for limiting passive investment type income, then it is believed that the rules should not be as strict as they are at present. If the passive investment gross receipts test is retained in a manner similar to that existing in present Section 1372(e)(5), then it is recommended that the 20% limitation be increased to 50% and that the definition of passive investment income be revised to exclude types of income which are generated from the active conduct of a trade or business, such as interest in small loan financing companies.

In lieu of retaining the passive investment income gross receipts test, it is recommended that serious consideration be given to the utilization of the personal holding company tests under Section 541. Under such a rule, the Subchapter S election would be terminated in any year in which there are accumulated earnings and profits at the end of the year and the corporation is a personal holding company as defined in Section 542. A corporation would be a personal holding company if at least 60% of its adjusted ordinary gross income for the taxable year is personal holding company income and if at any time during the last half of the taxable year more than 50% in value of its outstanding stock is owned directly or indirectly by not more than five individuals. Under this system, Subchapter S would be applying a set of rules which have been traditionally used for restricting passive investment activities of small groups of investors. This rule would be applied in conjunction with the capital gains option proposed by the American Bar Association for currently removing accumulated earnings and profits.

Should a passive investment income test or personal holding company test be imposed upon electing corporations with accumulated earnings and profits at the end of any year, then it is recommended that accumulated earnings and profits be defined for Subchapter S purposes as including accumulated earnings or profits arising only prior to the election. This restriction is necessary since tax exempt income and some accounting adjustments (e.g., §1377(d) and §312(k) relating to depreciation) may cause a Subchapter S corporation to generate accumulated earnings and profits under present law even though the earnings are not currently taxed to the shareholders.

Proposed Section 1362(d)(3) continues the present provision in Section 13 72(e)(5) which provides that the passive investment income restriction does not apply to a new Subchapter S corporation during its first two years if the passive income is less than $3,000. This is designed to permit a new corporation to invest its assets temporarily until the business operation gets started. Recognizing the impact of inflation and higher interest rates, it is suggested that the $3,000 limit be raised to a higher figure, not less than $10,000.

6. LIMITATION ON FOREIGN INCOME

Although earlier Treasury Department proposals have recommended deletion of the 80% foreign gross receipts test, it is noted that HR-6055 retains the present provision which terminates the Subchapter S election if more than 80% of gross receipts are derived from sources without the United States. It is believed that this is the result of an abundance of caution. In our review, members have ascertained no problems which warrant the continuation of this test and recommend its elimination.

7. STATE CORPORATION LIMITATIONS ON SECURITIES

A significant problem with the second class of stock limitation applies in the state of California and may apply in similar states. The California Department of Corporations reserves the right to condition the issuance of stock for services upon a restriction that the promoter agree to waive dividend distributions and to defer his right to payment on liquidation until cash paying shareholders have received a priority. In such case, both restrictions are generally removed as soon as the corporation becomes profitable. Ordinarily, such corporate securities restrictions may be lifted in California after a period of approximately three years. In Paige v. United States, 580 F.2d 960 (9th Cir. 1978), the Court treated dividend and liquidation restrictions as creating a second class of stock and invalidated the corporation. See also, Revenue Ruling 71-522, 1971-2 C.B.316. It is the recommendation of the Taxation Section that dividend or liquidation restrictions imposed by governmental agencies should not cause the corporation to be treated as having a second class of stock provided that the shareholders agree to taxation of the items of income and losses to the shareholders as if the corporate securities restrictions did not apply. I believe that the American Bar Association supports the California taxation section on this recommendation.

8. ELECTION REVOCATION AND TERMINATION

The Taxation Section supports in general the recommendations set forth in Section 1362 of the new bill dealing with election revocation and termination. The new provision that an election may be revoked by a majority of the shares of stock in the corporation is an improvement over the former requirement that 100% of shareholders must consent to the revocation. The former rule gave unreasonable economic powers to minority shareholders in controlling the future of the corporation. The removal of the right of a new shareholder to affirmative refuse to consent to the election is important for the same reasons. With 35 shareholders permitted under the new law, one new shareholder should not be permitted to control the economic destiny of the other 34 shareholders. The Section endorses the recommendation that disqualification will cause a termination to be effective as of the date of the event, rather than the first day of the taxable year as is the case under present law. The inadvertent termination rule under Section 1362(f) is an important remedial provision for correcting inadvertent terminations which are easily rectifiable by the corporation or its shareholders with the cooperation of the Secretary.

9. DISTRIBUTIONS OF APPRECIATED PROPERTIES

The bill proposes in Section 1363(d) that all distributions of appreciated property will cause a tax to the corporation as if the property had been sold to the distributee. We recognize the desireability of taxing ordinary income type properties in this manner in order to avoid the complex "hot asset" problems existing with partners under Section 751. However, we believe the Treasury proposal goes too far in taxing appreciation in capital assets or Section 1231 assets to the corporation. This is not consistent with the present scheme for taxing corporate distributions of appreciated property and is not necessary. We recommend that there be a pass through of basis to the shareholders upon the distribution of such capital assets or Section 1231 to the shareholders. Thus, they will have to pick up any tax resulting from appreciation on later disposition.

10. TAX TREATMENT TO SHAREHOLDERS

Among the most important parts of the new law are the provisions which provide that items of income, deduction, loss and credit will pass through to the shareholders and retain their character rather than being treated as dividends or capital gain under present law. For an electing small business corporation, this now establishes a more accurate method for truly reflecting the income to the shareholder and assuring that it will be taxed only once. The addition of a rule that provides that all items will be allocated on a per share per day basis also eliminates the variety of rules which now exists. Under present law, there is a last day of year test for income, an allocation based upon dividends for capital gains, and a per share per day test for losses. These different rules have frequently lead to confusion and are eliminated under the new law. The Tax Section supports the new provision which will finally permit a shareholder to carry forward any loss to the extent that the loss exceeds his aggregate basis in stock and debt to the corporation.

In general, new Section 1368 will establish a new set of rules for distributions which permit the distribution of cash by a corporation (which has no accumulated earnings and profits) to its shareholders without having a tax and without getting into the problem existing under current law of determining whether the distribution is one from undistributed taxable income or previously taxed income. This is a substantial improvement in Subchapter S and is consistent with the new format for treating items of income, deductions, credits and allowances as passing through to shareholders and being treated completely separate from distributions. This set of provisions in general is simpler in management and in the long view will be easier to use than the present system, since they apply rules similar to those applied in partnership taxation under Subchapter K.

11. DEFERRED COMPENSATION

The bill substantially reduces the qualified retirement plan benefits and other fringe benefits available to employee shareholders in a Subchapter S corporation. Under proposed Section 1372, the partnership rules for deferred compensation will generally be applied in determining retirement benefits and other fringe benefits for employees. Under the rules, any shareholder who owns more than 2% of the stock of the corporation will be treated as a partner and any shareholder who owns more than 10% will be treated as an owner/employee. The proposal fails to recognize that a true employer-employee relationship exists under corporate law and that those rules ought to be applied in examining that relationship in the tax atmosphere. It is believed that the artificial characterization of shareholder-employees as partners for some employment purposes will create more problems in the future than it will solve. Congress should encourage privately funded retirement plans in closely held businesses rather than impose additional restrictions which may tend to eliminate such privately funded retirement plans and thereby deprive rank and file employees of retirement benefits. Rather than seek ways in which to reduce retirement benefits for these employees, it is believed that Congress might better seek to expand retirement benefits for other business enterprises.

In connection with our evaluation of the application of partnership rules for "employee fringe benefits" our Section was faced with the prospect of finding no definition for the term. The vision of what is a fringe benefit depends on the eyes of the beholder. It is recommended that the concept be deleted and if it is retained, that the statute establish guidelines. Should a decision be made to retain the new partnership rules for qualified retirement plans and fringe benefits, it is recommended that the two percent rule be increased substantially to five or ten percent.

12. CORPORATE FISCAL YEAR

Although some reservations have been expressed concerning proposed requirements for all Subchapter S corporations to adopt a calendar year, the Taxation Section in general supports the conclusion that the proposal in Section 1378 establishes a realistic guideline for new Subchapter S corporations. The Section believes that it is not necessary to require existing corporations to convert to a calendar year when there is a significant change in ownership in the future. As presently drafted, the statute would cause the corporation to change its fiscal year to a calendar year at any time when more than 50% of the stock is "newly owned stock", unless the change is the result of the "death of a person who held such stock" on December 31, 1982. This arbitrary 50% test will, in some instances, cause an unnecessary restraint on future alienation of stock in closely held S corporations since transfers must ultimately result in the fiscal year being changed in the future. If a percentage test is applied, it is recommended that a set of attribution rules, such as those applied in Section 267(b) and (c) be applied before a determination is made that there has been a more than 50% creation of "newly owned stock".

13. TREATMENT OF EXPENSES AND INTEREST IN TRANSACTION BETWEEN THE S CORPORATION AND STOCKHOLDERS

The bill amends Section 267 of the code to provide that the S corporation may not take a deduction for expenses or interest paid to a related person until the year in which the item is includable in the income of the related person. In general, the California Taxation Section supports this provision as it will reduce opportunity for a distortion of income which may exist when the corporation is on an accrual method and the related payee is on a cash method. We are concerned about overt discrimination against the Subchapter S corporation which will exist under the proposal since standard C corporations are currently given a 2 1/2 month grace period within which to make the payment after the end of the corporations year under §276(a) (2) but this privilege will be denied Subchapter S corporations. In addition, this new application of Section 267 will apply to Subchapter S corporations not to partnerships. We recommend that the 2 1/2 month payment rule be given to Subchapter S corporations.

14. TAX AUDIT AT CORPORATE LEVEL

The Taxation Section endorses in principle the concept that the Code should establish standards for causing the tax treatment of the Subchapter S corporation to be determined in a single audit at the corporate level. Recognizing that this is an issue which has been the subject of extensive discussion for both Subchapter S corporations and partnerships, it is recommended that action be deferred on this matter until the many potential administrative problems have been resolved. At that time a comprehensive statute should be enacted.

15. SUMMARY

In conclusion, it is the belief of the Taxation Section of the California State Bar that the Subchapter S Revision Act of 1982 is a major improvement in federal taxation which will substantially simplify Subchapter S and will result in many more businesses taking advantage of the opportunity to engage in business in the corporate form without suffering significant economic detriments which may be caused by the dual corporate tax structure. The Taxation Section supports the enactment of HR-6055, and requests that the Committee give serious consideration to the proposals and comments which we have made. Recognizing the many years of hard work which have gone into the development of this bill, we strongly encourage Congress to act on the bill this year.

Chairman STARK. Thank you, gentlemen.

Tell me the corporate ground rules here. If we deal with a corporation that has, say $3 million in assets, $1 million in cash and $2 million securities, and at a cost basis of $1 million, $1 million was the shareholder's basis and the corporate earnings were retained.

Now, it seems to me that if they convert or if they liquidate today, they pay a gain on $2 million. They pay $400,000. Let's assume the $1 million basis could take home the $1 million cash, so they pay $400,000 on the $2 million in gain, and they could take $1.6 million home in addition to their $1 million investment. Do I get an A so far from the panel here?

If they can convert free, then they only pay as they draw it out, and nobody is suggesting they ought to be able to do that; is that right?

Mr. NOLAN. Right.

Chairman STARK. Now we are sort of in the middle. If under the ABA proposal, I gather they are suggesting pay capital gains on the value of securities, say, that had a cost of $1 million and went to $2 million. In other words, the increase in the assets within the corporation, they pay capital gains on that.

In my example I am assuming those securities of $2 million had a cost of $1 million, so you pay a capital gain on that capital gain or on the earnings, the retained earnings would be $200,000. And then you could distribute the $800,000.

Mr. NOLAN. I am getting a little lost on your figures. That we are basically suggesting that the accumulated earnings of the corporation would be taxed to the shareholders if they so elected that treatment, and that would permit them all of the benefits of the new, better system, and the rationale of that is that if they liquidated the corporation they would pay a tax on those accumulated earnings.

There is not any need to pay a capital gains tax with respect to assets that have appreciated in value because the basis will carry over. What we are focusing upon is the accumulated earnings and profits. That is the real problem here, and there ought to be an option available to corporations and their shareholders, if they want it, to pay tax on those amounts, in which case they would get all of the benefits of these new rules.

Chairman **Stark**. What I see here, the Government comes up $300,000 short, if I am doing my arithmetic right. Let's just assume we want to stay even, but basically on the example that I am talking about, if they convert, and then distribute, they pay $200,000 on the appreciated securities.

So out of that $1 million they would get $800,000 in their pocket. Then if they distributed the other $1 million, they would pay personal tax of 50 percent on that. So they would only get $500,000 out of that second $1 million.

The first $1 million was their basis, so they just take that home, so they get $1.3 million out of that $2 million in their pocket.

Out of the other program, if they just took a capital gain, they would pay $400,000 and they would have $1.6 million. If that could be distributed subsequently without a tax, they could effectively put $300,000 more in their pocket under that system than they could under the present system.

Mr. **Diss**. If I may comment, Mr. Chairman, the AICPA in principle opposes this toll charge, but we are prepared to go along with it as a legislative compromise, and again it would only apply to a personal holding company that wanted to elect subchapter S. As we understand your figures, it would be impossible to distribute the $1 million equal to the shareholders basis under present law without triggering a dividend tax, because of the presence of the accumulated earnings and profits of $2 million.

However, under this toll charge proposal, the $2 million would be taxed over a 5-year period as capital gain to the shareholders, and they would thereupon be allowed to withdraw those $2 million in funds without paying any further tax. This would also require further complication in the tax law to prevent bailouts, resumption of subchapter S treatment, accelerations upon sale of the stock, and so forth, Congress might decide to drop the whole thing and permit straightforward repeal of the passive receipts test without creating these additional problems. But we are prepared to go along with this 5-year capital gain toll charge for an electing personal holding company.

Mr. **Shaw**. Mr. Chairman, may I comment?

Chairman **Stark**. Yes.

Mr. **Shaw**. Thank you. I believe it is helpful to compare the present and the future. Under present law, under subchapter S, a corporation with accumulated earnings may elect subchapter S, and that corporation has no immediate tax impact. It simply makes the election, the accumulated earnings are on the books, and its proceeds. Future income will be taxed to the shareholders as constructive or actual dividends.

When the distributions exceed the current income, then distributions are deemed to be from previously taxed income, and when it has distributed that, then, third, it would be subject to tax on any accumulated earnings and profits. So under present law, when you make an election under subchapter S, you are not going to pay any tax until you have taken care of current earnings, have distributed the previously taxed income, and then, finally, that category of preexisting accumualted earnings will be taxed as distributed. So there is no pickup tax at the time of the election. Now if we move forward——

Chairman **Stark**. It would be taxed at ordinary rates, at the 50-percent rate to the taxpayer?

Mr. **Shaw**. At the time there are distributions from the corporation it will be taxed to the shareholders at the ordinary income rates as a dividend.

Chairman **Stark**. Yes.

Mr. **Shaw**. Under the present bill, when the election is made with accumulated earnings, the accumulated earnings simply sit there. There is no pickup tax. Under the present bill, as income is earned and the items pass through to the investors, they will pay tax on those items. They have an adjustments account which accumulates for the passthrough of the net income, the items of income adjusted by expenses. That adjustment account accumulates. When distributions of cash from the corporation exceeds this adjustments account, then the accumulated earnings will be taxed to those investors at ordinary income rates.

Now, it seems to me that the controversy really arises over the issue as to whether or not, No. 1, we need to retain the passive investment income test just because it relates to the issue that Mr. Nolan was talking about earlier—where there is a possibility that one might escape taxation on accumulated earnings by converting ordinary assets to investment assets, and keeping them in the corporation. The individual ultimately dies. The shareholder has a step-up in basis, and disposes of his stock by liquidation or whatever. That is where the rub really is. It arises from the relationships this passive investment concept with the step-up in basis at death.

Mr. **Nolan**. Mr. Chairman, can I say this: We are proposing this concept, which has really been developed by Professor Ginsburg and which we endorse, because it is very important to us that the integrity of this collegial process be preserved.

We must not put through a bill in the name of simplification that opens up a new loophole in the law. We can't do that. It will destroy our credibility, so we are very anxious to put these bills together in a way that we do not create any new tax opportunities.

There is no question that in the world today the corporate tax regime can be much more favorable than the individual tax regime. The tax rates on the first $100,000 of corporate income are lower, and there is always pressure to increase that level of lower corporate tax. Also, there are various rules that are applicable to individuals that are not applicable to corporations. It is a simple fact that you can get a better tax deal if you can earn your income in a corporation. We must not create a situation here which allows people to take advantage of all of those rules, and then never pay a tax at the shareholder level on that income.

All we are proposing here is that corporations who want to make election to pay tax on accumulated earnings should be able to do so and get the benefits of this new subchapter S treatment. But if thev don't do so, we are not going to let them use subchapter S to get the benefits of all of the earnings they have built up, receiving all the earnings on those, and never pay any tax on that original buildup. We are going to have a passive income limitation, unless they elect to pay tax on their accumulated earnings.

Now, what we are proposing is a solution that is essentially the same as what would happen if they liquidated their corporation and paid a tax at the shareholder level, with one exception. We tax the earnings and profits. We do not tax any unrealized appreciation in the assets which would occur on a corporate liquidation, but neither do we give them a step-up in basis on those assets as would occur in a corporate liquidation. The basis remains the same so they do not get any advantage with respect to assets that have appreciated in value. We do tax them on the accumulated earnings. We think this is a fair system, and nobody is forced into it.

Many people will elect it, and in doing so, they will make available to themselves all of the wonderful advantages of this new bill, but at the same time we will prevent any tax avoidance in that process.

Chairman **Stark**. They do get a step-up in basis on transfer at death, though. Then they would because it would just be assets of the corporation?

Mr. **Nolan**. At death there will be a step-up in basis, but of course that is going to occur anyway, and all we are doing is being sure that it doesn't get made any worse by this process.

Mr. **Diss**. That basis step-up would relate to the stock held by the deceased shareholder, not to the assets inside the corporation.

Chairman **Stark**. Thank you very much, gentlemen. I am sure we will have additional questions, and I hope you will be kind enough to respond to them and they will be made part of the record.

Our next panel consists of Mr. Bernard M. Shapiro, national director of tax policy for Price Waterhouse; Mr. Richard L. Thomas, partner in Arthur Andersen, head of their subchapter S specialty team; Mr. Donald Alexander, member of the Taxation Committee of the U.S. Chamber of Commerce; and Prof. Martin Ginsburg, Georgetown University Law Center.

Welcome back. Bobby, your suits are certainly fitting a lot better these days. How is life on the outside?

Mr. **Shapiro**. Just fine, Mr. Chairman. It is a pleasure to be back before the committee.

Chairman **Stark**. It is good to have you back. Actually, I guess you are the guy that started all this some years ago, so why don't you lead off and explain to us what we ought to do.

STATEMENT OF BERNARD M. SHAPIRO, NATIONAL DIRECTOR OF TAX POLICY, PRICE WATERHOUSE

Mr. SHAPIRO. Thank you, Mr. Chairman. Good morning. For the record, my name is Bernard M. "Bob" Shapiro. I appear this morning in my role as the national director of tax policy for Price Waterhouse. I commend the committee and the staff and the whole collegial process for the effort that has been taken in bringing forth the subchapter S revision to the point that it is today.

You are right, Mr. Chairman; it is an area that I have had a personal involvement for the entire 15-year period that I was on the joint committee staff. Let me start with that and give some background as to that process, and then comment very briefly on some of the substantive areas that we are going to hear.

I know that Professor Ginsburg and Mr. Alexander will spend a considerable amount of their time focusing on the issue of the regular corporation to subchapter S, which is the major controversial issue before the committee.

As we know, the subchapter S provisions deal with the situation where a small business would like to be a corporation for business or legal purposes, essentially to have limited liability, but wants to be taxed as a partnership to avoid the double tax that applies to the corporate tax structure. As a result of this, the Congress, in 1958, provided a hybrid type of entity for tax purposes allowing a corporation to maintain its corporate status so its shareholders could continue the legal benefit of limited liability, but elect to be taxed in a manner somewhat similar to a partnership, but not the pure passthrough type situation that applies to partners in a partnership. That is why it is a hybrid, and therefore you have the benefit provided in the subchapter S corporate status.

Because of the hybrid structure, a number of problems existed afer 1958, such as inadvertent terminations and various traps that had occurred in the case of these Subchapter S corporations. Very early after the problems of this new status began to become known, in the middle 1960's, the Treasury Department, in conjunction with the joint committee staff, the American Bar Association, and the American Institute of Certified Public Accountants, met to try to develop a process to review these problems in subchapter S. That was the first project that I participated in when I joined the staff in 1966.

We developed a package containing a series of revisions that the Treasury Department published in its Tax Reform Studies submitted to the Congress at the end of the Johnson Administration. Also, in 1969 the new administration presented essentially these same subchapter S proposals to the Congress during the course of the tax reform deliberations by the Ways and Means Committee. However, the Ways and Means Committee in 1969, did not have an opportunity to consider all of the subchapter S provisions because of the time restraints that it had. The committee just dealt with one provision, which was a tax reform tightening provision applying the more restrictive H.R. 10 pension limitations to the shareholders of subchapter S corporations. These were the same provisions that applied to partnerships rather than the generally more liberal pension-type treatment that was available for corporations.

In the early 1970's and during the course of the decade, the Congress considered some of these subchapter S provisions in that package and did adopt a few. However, the package itself was not considered, as there was not time in the congressional time schedule to deal with it because of the pressures of other tax legislation before the Congress.

Mr. Chairman, let me now review the background that led the Congress to develop a process for tax simplification.

In 1976, in the tax reform bill there, the Congress passed another project that I started with way back in 1966 that took 10 years to be enacted, which was the "deadwood bill." This project took us through the entire Internal Revenue Code, to cull out unnecessary, so-called deadwood provisions, by eliminating the areas that had expired, such as special transition rules that were outmoded, or rules that were no longer applicable and could be repealed. The concern was that if a process of eliminating deadwood took 10 years to be enacted, projects such as subchapter S and other tax simplification were going to have trouble in getting the Congress attention because of other scheduling pressures.

As a result, in 1977 the staffs of the joint committee, Ways and Means Committee, and Finance Committee, met with the chairmen, the ranking members, and the subcommittees on tax measures, to try to develop a process to consider simplification. We started out with a series of small, minor provisions which went very smoothly through the process.

The first major provision to use the process was the installment sales bill. It was a more complex set of provisions. It was passed in 1980, and achieved a major success in the simplification process in the Congress.

The next major effort was subchapter S which involved a whole subchapter rather than just a series of provisions that had been considered in prior simplification projects. The joint committee staff published a document in 1980 that set forth the tentative decisions and recommendations that had been made in the collegial process up to that time, intending to promote comments and reactions. A number of the reactions dealt with some of the changes that are being addressed at this hearing.

A major difficulty the staff had in the past was the drafting of the subchapter S provisions because of the demands on the legislative council's office as a result of all the recent tax legislative activity. During the past year, the staffs found some breathing room in the pressure of the legislative counsel's office and working with the collegial process developed a draft bill, which is presently before the Congress.

I would like to point out that the subchapter S project is almost 20 years old. It is important in my judgment to do everything possible to have these provisions enacted this year.

Let me take a few minutes and summarize some of the areas that you have asked for comment. As I said, Mr. Alexander and Professor Ginsburg will go into more detail on the major one of converting from a regular corporation into a subchapter S corporation. I essentially endorse the remarks made by Mr. Nolan on behalf of the American Bar Association that it is very necessary to develop a means to avoid potential tax abuse. Some form of an elective approach can do that.

Let me point out one area in the Code that I thought may be followed as a model for this problem. In subchapter J of the Internal Revenue Code there are special provisions to deal with what are referred to as simple trusts and complex trusts. Trusts are enacted for many reasons, as we all know. Some trusts are straightforward and some extremely complicated. Congress enacted two sets of provisions for trusts. In the case of trusts referred to as simple trusts, which essentially are conduits, in which case all of the current income is required to be distributed to beneficiaries currently, the rules are relatively simple. All other trusts essentially those which may accumulate income, and where there is discretion with the trustee, there are separate, so-called complex trust tax rules that apply to those trusts.

I suggested, when I was on the staff, that we try to model subchapter S to have simple rules for simple subchapter S corporations, and complex rules for those that essentially have E. & P., which are the complex situations. The staff studied this suggestion and reported back that the complexities that would exist were significant enough that we agreed not to pursue that direction.

When the staff published its subchapter S recommendations in 1980 proposing no change from the present rule with regard to the conversion from the C to S situation, we started hearing of tax planning that was going on in anticipation of the subchapter S changes with repeal of the passive income limitation and other aspects that gave us much concern as to how to deal with it.

It brought forth suggestions to provide a toll charge, for the type of situation which I cover in my statement, that is, to have an elective-type rule where we have a simpler set of rules for corporations that have cleansed themselves of any taint, referring to the E. & P. while in a regular corporate status, and thus could benefit from all the liberalizations in the revisions of subchapter S. But for those corporations that do not, then possibly to have the more complicated rules, in somewhat of an analogy to what we have in the trust situation.

In the case of the one class of stock issue, I feel that there is a strong argument for simplicity to maintain the present rule of one class of stock, for the various reasons that Deputy Assistant Secretary Glickman gave in his testimony, and which has been supported by the panel before us.

However, I am equally concerned about the possibility of shifting a debt into a second class of stock, resulting in a trap where a subchapter S corporation is not aware that it may be disqualified, and with the adverse impact that may have.

I can give you a simple example to show the problem. The way you get basis in a subchapter S corporation is either through capital contributions for stock, or loans that are made directly to the corporation.

If the subchapter S corporation borrows money from a bank and the shareholder has to guarantee it, the shareholder does not get an increase in basis. As a practical matter, there is no difference whether the shareholder guarantees the debt to the corporation or the shareholder borrows the money himself and then loans it directly to the corporation. In this case, however, the shareholder gets basis; in the other case, he does not.

If, however, the shareholder borrows the money directly and loans it to the corporation there is the possibility that the corporation may be disqualified from subchapter S status because that debt may be treated as a second class of stock.

Now I do recognize that there may be some problems with potential abuses and tax avoidance incertain debt equity type situations. What I am suggesting is that we should develop the types of rules that do not disqualify non tax-avoidance situations but only focus on those cases where a hybrid type situation of debt may be tax avoidance motivated we should provide something to protect against the 385-type regulation rules in subchapter S corporations. There is not the same significance between debt and equity that occurs in a corporation, the deduction of interest on debt avoids the corporate tax.

Very briefly, I would like to comment on the issue of the 80-percent foreign source income requirement. The existing 80-percent level means there already is a significant level of foreign source income that can already be received. We have reviewed the legislative history, and I have looked at the study that we had which resulted in the 1980 recommendations of the staff. There does not appear, from the legislative history, to be a reason not to eliminate that 80 percent requirement as the staff recommended in 1980, and for that reason it would appear to us that there should not be any limitation on foreign source income, especially since the individual is taxed on both the domestic and foreign income in any event.

To the extent there are cases that have not been brought out, certainly we would review that recommendation, but without being aware of any specific cases, it would appear to be appropriate to eliminate the 80-percent limitation.

Finally, Mr. Chairman, let me conclude by again strongly supporting the legislation and recommending that this subcommittee, the full committee, and the Congress do everything possible to expedite the enactment of this legislation, hopefully this year. Thank you, Mr. Chairman.

[The prepared statement follows:]

STATEMENT OF
BERNARD M. ("BOB") SHAPIRO
NATIONAL DIRECTOR OF TAX POLICY
PRICE WATERHOUSE

I am Bernard M. ("Bob") Shapiro. I appear here this morning in my capacity as the National Director of Tax Policy for Price Waterhouse to express my strong support of the legislation to revise Subchapter S of the Internal Revenue Code.

This is an area in which I had a personal involvement during my fifteen years with the staff of the Joint Committee on Taxation. I think it would be helpful background for me to summarize the consideration of the revisions to Subchapter S during this period. Thus, Mr. Chairman, I am going to direct my testimony to two areas: first, an overview of the revision process; and second, some comments on possible areas for change. My comments include remarks on issues suggested by Chairman Rostenkowski in his floor statement when H.R. 6055 was introduced. I do not intend to comment on all the bill's provisions, since I am in general support of the legislation and understand the various considerations that entered into some of the decisions which are in the proposed legislation.

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At the outset, I would like to strongly urge this subcommittee, and the full committee, to consider and complete action on this legislation in time for the President's signature this year. It is welcomed legislation needed by practitioners and electing corporations. It clarifies the law to make the tax code more workable and eliminates certain inadvertent traps that were not intended by the original legislation. It is all too easy to defer it until the next Congress in an effort to try to work out all the differences. Let me hasten to add, however, that it is a rare piece of legislation that receives total support for all provisions. Any time you deal with a major area, there are quite naturally different views on specific provisions.

I. BACKGROUND OF TAX SIMPLIFICATION PROCESS

Let me review for you the background of the tax simplification process that began in 1977 when Laurence N. Woodworth became the Assistant Treasury Secretary for Tax Policy and I succeeded him as the Chief of Staff of the Joint Committee on Taxation. Larry and I and our respective staffs met with both the majority and minority staffs of the House Ways and Means Committee and the Senate Finance Committee to initiate a process for simplification. Various staff members then met with the Chairmen and ranking members of those committees, as well as the Chairmen and ranking members of the tax subcommittees of the respective committees, to discuss and receive their approval for these staff initiatives. We started out with a series of small and minor changes to the tax code to initiate the process. This went very smoothly, with strong support from the members' staff, the Treasury Department, and various professional groups who assisted in the process. The first major effort was the Installment Sales Revision Act of 1980 (P.L. 96-471), which was enacted into law on October 19, 1980. This was a limited area of the code, but some of the modifications were controversial and it was the first significant test of the simplification process. It survived and the installment sales legislation was received enthusiastically in the tax committees as a major success for tax simplification. We next turned our attention to a larger area for simplification, which was a revision of an entire subchapter. We first focused on the Subchapter S provisions, a project which had been started in the early 1960's.

II. HISTORY OF SUBCHAPTER S PROVISIONS

First a word about the reason and purpose for the Subchapter S provisions in the tax laws. Subchapter S was enacted to deal with the problem of a small business which wanted to incorporate the business entity for legal purposes but preferred to be treated as a partnership for tax purposes. A legal benefit to incorporation is the "limited liability" of the shareholders for the corporation's actions and liabilities. A partner, on the other hand, is generally liable for the actions and liabilities of the partnership, except where certain partners have a special status of "limited" partners. The tax consequences of a corporate structure generally subjects the profits of the entity to a double tax: first, at the corporate level, and second, at the shareholder level, as the after-tax profits are distributed as dividends. The tax benefit associated with partnership status is the one level of taxation -- a partnership is merely a conduit through which the tax characteristics of the business are passed through to the individual partners and the income is not taxed at the partnership level.

In the 1950's, Congress was made aware of the concern of small business regarding the difference in the tax treatment depending on whether the business was a partnership or a corporation. It was apparent that an adverse impact existed where a small business wanted to be taxed as a partnership, but also wanted to be formed as a corporation in order to have the legal protection of limited liability to its shareholders. The belief was that there should not be a distinction in the tax treatment of small businesses, whether formed as a corporation or as a partnership. As a result, in 1958, Congress enacted Subchapter S of the Internal Revenue Code, which permitted the owners of a business which had incorporated the entity for business and legal purposes to elect to be treated for tax purposes in a similar manner as a partnership.

In its effort to limit this special classification to small businesses, a major decision had to be made by Congress as to what test to use for size. Many problems existed with a size determination based on gross receipts. Thus, Congress settled on the number of shareholders as a means to determine size. At the outset, Congress limited this special small business election to corporations with 10 or fewer shareholders.

These Subchapter S rules were generally intended to be patterned after the partnership tax rules. Because the entity is a corporation, however, it is a "hybrid" for tax purposes requiring many special and unique rules. It is quite natural that unanticipated problems became obvious which required revisions.

In the early 1960's, an effort was initiated by the Treasury Department in coordination with the Joint Committee staff, and the Tax Section of the American Bar Association, to review the Subchapter S provisions to determine how they were working in practice. A number of problems had already surfaced, ranging from inadvertent terminations to basic treatment of the various characteristics of the income, deductions, profits, and losses. In addition, there was a general view that the Subchapter S concept had been accepted and therefore, some of the more restrictive elements of the 1958 law could be expanded to cover more situations. Periodic meetings of the Subchapter S working group were held over the years. These discussions resulted in a Subchapter S revision package/which was included in the Treasury Department's tax reform studies released at the end of the Johnson Administration.

In 1969, when the Congress considered tax reform, Subchapter S changes were on the initial agenda of the Ways and Means Committee. However, the effort for tax reform covered so many areas that when the Subchapter S provisions came before the Committee, it appeared too massive an area for consideration at that time. It subsequently was deferred except for one very major tax change that was adopted by the Ways and Means Committee and ultimately enacted into law. The "H.R. 10 pension limitations," which applied to partnerships, were extended to apply to shareholders of Subchapter S corporations in lieu of the more liberal pension rules for corporations generally. The H.R. 10 limitation was considered by the working group as a "tradeoff" for some of the expanded areas of Subchapter S, including the repeal of the passive income limitation. None of the other provisions, however, were enacted.

During the 1970's, in the various tax acts that were passed, a few provisions were enacted that were contained in the Subchapter S proposals of the Treasury Department in addition to other needed revisions. Also, the Economic Recovery Tax Act of 1981 expanded Subchapter S corporation size to the present level of twenty-five shareholders. However, the major revisions involving the more detailed modifications of Subchapter S which would make it more workable and easier to understand were not considered because of time pressures.

In 1980, the Joint Committee on Taxation staff published a document setting forth all of the proposed revisions that appeared to have a consensus at that time from those working on Subchapter S revisions. There was an effort to have a bill drafted then but, because of the demands of other tax legislation, the drafters were unable to do so. I am proud to see that one of the major accomplishments of the Congressional staffs in the simplification area since I left has been their perseverance to go forward with the drafting of a bill. This effort required a great deal of support from many staffs, including the House Ways and Means Committee, the Senate Finance Committee, the Joint Committee on Taxation, the Treasury Department, and the Tax Sections of the American Bar Association and the American Institute of Certified Public Accountants. I would also especially like to commend the efforts by the Legislative Counsel's Office in the actual drafting process.

I am well aware that not everyone supports all of these provisions and that several items have been left open for further consideration, but I want to again strongly urge the committee to utilize every means possible to enact a Subchapter S revision bill during this Congress. As I have tried to illustrate, these changes did not just appear this year. Rather, it is a process that has been going on for almost twenty years with a tremendous amount of time and effort contributed by a countless number of people. The bill represents a major simplification effort and is an appropriate expansion of the use of Subchapter S. It benefits not only the practitioner who must apply the law, but also small businesses that would like to take advantage of these rules. I would suggest that any areas of difference that continue to exist be worked out in a normal process of compromise. A lot of good faith has been built up in the tax community and the professional organizations regarding this effort.

III. COMMENTS ON SPECIFIC PROVISIONS

Let me now address several of the key substantive issues that are still in question. First let me repeat that on balance, I believe the proposed legislation is a substantial improvement over current law. Therefore, I am not going to take the time to critique all of the provisions, but rather, to generally endorse the bill. I will address only those points that you have requested comments on and some additional issues.

Election of Subchapter S by Regular Corporation

Under present law, the Subchapter S election may be made by a regular corporation without any immediate tax effects to either the corporation or its shareholders. The earnings which accumulated prior to the Subchapter S election are preserved and taxed as dividends when distributed to the shareholders. Conversely, when a corporation liquidates and then continues to conduct business in partnership form, present law does not allow the deferral of shareholder tax even though the same individuals who were shareholders are now partners. The basis of the corporation's assets to the partnership is then increased to fair market value.

Because the bill provides Subchapter S corporations with more partnership-like treatment, the question has been raised as to whether a similar "toll charge" should be enacted for regular corporations electing Subchapter S status similar to the treatment of corporations converting into partnerships.

When the staff considered this issue in its 1980 study, it decided not to change existing law in this area. However, the reaction and comments that were received by the staff led them to believe that possible "gamesmanship" could be practiced in certain cases by shifting from corporate status to Subchapter S status, without a toll charge. In view of this, discussions took place to resolve this potential abuse. This issue was left open in the bill before the committee and existing law was continued. This is the major issue on which comments were requested.

Let me take a moment to give some background on my personal involvement in this matter. When this issue came before the staff at an early stage, I suggested the possiblity of modeling this aspect of the Subchapter S revisions after the tax rules that apply to trusts in Subchapter J of the Code. There are a variety of reasons to establish a trust. The tax policy relating to trust taxation results from the decision of Congress that a trust, which is required to distribute all its current income to beneficiaries (with two other lesser important requirements), should have a simpler set of rules than a trust, which gives the trustee discretion or requires current income to be accumulated in the trust for future distribution. The tax laws take cognizance of this by providing two distinct sets of rules. Subpart B of Subchapter J contains the "simple" trust rules which are not as involved, as those provided in Subpart C of Subchapter J dealing with all other trusts ("complex" trusts).

At that time I suggested the possibility of approaching the problem with Subchapter S in somewhat the same manner. That is, to provide a simpler set of rules for companies which had no accumulated earnings and profits from pre-Subchapter S years. A different set of rules could be established for those corporations with accumulated earnings and profits from years in which they were regular corporations. My thoughts were to parallel the concept of Subchapter J rules for simple and complex trusts by providing different rules for simple and complex Subchapter S corporations. The staff reviewed this concept and subsequently reported to me that the complexities appeared to outweigh the merits. Because of the desire for simplicity, it was decided to continue the existing rules and not exact a toll charge for regular corporations electing Subchapter S status.

I understand the concerns regarding the possible manipulation that could occur if we continue existing law in this area.

Proposals have been advanced to develop a special "toll charge" on an elective basis for corporations which have accumulated E&P. This election would eliminate the taint associated with those corporations electing Subchapter S treatment. However, I am aware that this type of proposal has some strong critics regarding other associated implications and complexities. I expect these points of view to be fully developed in the statements and testimony before the subcommittee.

Mr. Chairman, as I have indicated, I feel that it is extremely important that the Congress enact Subchapter S legislation this Congress. The revisions have been such a long time in coming and have now advanced so far in the simplification process that I am concerned about the outcome if the legislation is put aside and we have to begin anew in the next Congress. I am eager to work with the staffs and the Treasury and those involved in these proposals to develop the most workable solution to this problem.

Mr. Chairman, I would like to suggest a fallback position which I would advocate only if necessary to move the legislation this year as a means to at least get the new, simpler rules in place. That is, a structure for Subchapter S corporations that provides separate rules for simple and complex situations.

The new rules contained in the legislation could apply to "simple Subchapter S corporations" which could cover all newly formed corporations that elect Subchapter S status, Subchapter S corporations that have no accumulated E&P (possibly including those corporations which have no accumulated E&P from pre-Subchapter S periods but have minimal accumulated E&P during the Subchapter S years as a result of certain tax accounting differences, such as depreciation), and those corporations that make the partnership-type election and pay the resulting toll charge. In so doing, certain other rules, such as the passive income limitation, could be eliminated with respect to these corporations.

A so-called "complex" strucure would apply to all other Subchapter S corporations which have accumulated E&P. If workable provisions are not agreed to, then for convenience, the present Subchapter S rules could be continued with respect to these corporations.

On the surface, this may be more complicated because it would coincide with new rules. Clearly this is not a step in the direction towards simplification. However, my objective would be to get the new rules in place in a simplified manner for those corporations that do not have accumulated E&P. This would vastly simplify the Subchapter S provisions. It would afford an opportunity to continue working on the problem of allowing corporations with accumulated E&P to elect Subchapter S status.

I would advocate this result only under the circumstance that a solution to the accumulated E&P problem is not obtainable in this Congress and that the legislation would die otherwise, thus requiring beginning all over again in the next Congress. I am concerned that the enthusiasm for the project would not be sustained at its present level, since so many who are involved believe that we are very close to completion.

Passive Income Limitation

Under present rules, a Subchapter S election is terminated for any taxable year in which the corporation's income from passive-type investments exceeds 20% of gross receipts. The purpose of a passive income limitation was to make Subchapter S status available only to corporations engaged in active trades or businesses and to prevent taxpayers from incorporating investment activities and electing Subchapter S status in order to benefit from the corporate pension plans.

The passive income limitation has caused many inadvertent disqualifications of Subchapter S elections, in addition to a substantial amount of disputes regarding the definition of what constitutes passive income. The bill would continue this rule for corporations with accumulated earnings and profits. Effectively, the bill would exempt from the passive income test only corporations formed after the effective date of the bill and electing Subchapter S treatment immediately.

The removal of the passive income limitation has raised concern that the Subchapter S election could be used to avoid shareholder tax on accumulated earnings, where the corporation has ceased to conduct an active business. Although complete elimination of the passive income restriction is desirable, we agree that certain loopholes or unwarranted tax savings might be available if the limitation were repealed. If the problem of the accumulated E&P situation were to be resolved to remove the taint, there would be no need for any passive income limitation. Under a simple/complex Subchapter S scheme, the limitation would be removed for the simple Subchapter S corporations but would be retained for the complex Subchapter S corporations. In any event, in those cases where the limitation is to be retained, it would appear appropriate to raise the maximimum allowed level of passive income from 20% to possibly 50%. In this way, the potential situations which could be considered abusive would be covered. Additionally, the situations, under present law, which are clearly inadvertent violations of the restrictions, would most likely be relieved from termination penalties.

One Class of Stock Requirement

Under present law, a Subchapter S corporation is barred from having more than one class of stock. The reason for the one class of stock requirement is the complexities involved in allocating income and losses to a second class of stock. The bill would allow differences in the voting rights in the Subchapter S corporation's common stock.

In certain situations, a purported debt instrument could be reclassified as stock. The courts have allowed certain instruments to exist under present law because no tax avoidance possibilities were available, even though the debt would normally be considered equity for tax purposes. The IRS has indicated that it will not litigate cases factually similar to these judicial precedents. It appear obvious, therefore, that the courts have taken a very reasonable and practical approach in dealing with the debt vs. equity issue as it relates to Subchapter S corporations.

We believe that the one class of stock requirement should be continued because of the simplicity of allocating income and losses. In this connection, the Congress should adopt the same reasonable interpretations that the courts have held on the one class of stock issue by not reclassifying debt as a second class of stock unless there is a tax avoidance motivation. We strongly recommend, however, that the rules clearly indicate that the Subchapter S election will not terminate with an inadvertent reclassification of certain debt instruments as stock under the so-called "385-type rules." This is particularly important because Subchapter S losses can only be deducted to the extent of a shareholder's basis in his stock plus the basis of direct loans from the shareholder to the corporation. In order to have adequate basis to deduct Subchapter S losses, shareholders generally are forced into making direct loans to their corporations, rather than simply guaranteeing the corporation's debt. Accordingly, Subchapter S shareholders need some degree of assurance that they have met the one class of stock requirement where such direct loans have been made to the corporation. Complete assurance could come from an exception from the 385-type rules for Subchapter S corporations. Alternatively, if it is felt that the exception from the 385-type rules is not warranted, the IRS could be given broad latitude in waiving a termination of an election due to the reclassification of debt as equity. In any event, it is imperative that taxpayers electing Subchapter S treatment have some degree of certainty that the disastrous effects of a termination of their election will not occur because of the debt/equity issue as it applies to the one class of stock requirement.

Foreign Source Income Limitation

Presently, a Subchapter S election is terminated for any taxable year during which the Subchapter S corporation's gross receipts from foreign sources exceed 80%. The bill would continue this rule.

The legislative history of Subchapter S does not clearly indicate why the foreign source income limitation was enacted. Furthermore, the 1980 study recommended repeal of the foreign source income limitation. This recommendation was in part due to the lack of legislative history on the restriction and the fact that Subchapter S shareholders are taxed currently on the corporation's earnings from both domestic and foreign sources. In addition, the 80% limitation provides, at best, only a minimal level of restriction.

Based on this, it is unclear why the foreign source income limitation should be continued.

Affiliated Groups

Under present law, a member of an affiliated group of corporations is not eligible for a Subchapter S election. In other words, a corporation that elects Subchapter S status cannot own 80% or more of the stock of another corporation unless such corporation is inactive. The bill would retain this rule regarding affiliated groups.

Due to the bill's substantial modifications to the Subchapter S rules, it is expected that a significant number of corporations who are members of an affiliated group will consider a Subchapter S election. In addition, because the bill allows corporations a 3-1/2 month "look-back period" in which to decide whether to elect Subchapter S, there is a problem with the interaction of the consolidated return regulations with the qualification rules of Subchapter S. For example, assume a calendar year parent company filing a consolidated return wants to liquidate its wholly-owned subsidiary within the 3-1/2 month period in order to elect Subchapter S status. Furthermore, assume that the liquidation occurs on March 1 of the group's tax year. Because the subsidiary is required to be included in a consolidated return for the two months of January and February, the parent corporation is prevented from electing Subchapter S until the following calendar year, even though on the date the election is required, the parent corporation is no longer a member of an affiliated group.

We feel that any legislation revising the Subchapter S rules should either modify the Subchapter S affiliated group rules to provide an exception, or allow affiliated groups to elect to "disaffiliate" in order to file separate returns for the short tax year in order to qualify for the Subchapter S election.

* * * * *

I would like to thank this Subcommittee for allowing me the opportunity to appear here today and present our firm's views on this important legislation to simplify the tax code.

Price
Waterhouse

Chairman **Stark**. Thank you, Bobby.

Mr. Thomas.

STATEMENT OF RICHARD L. THOMAS, TAX PARTNER AND HEAD OF SUBCHAPTER S SPECIALTY TEAM, ARTHUR ANDERSEN & CO.

Mr. **Thomas**. I am Richard Thomas of the firm of Arthur Andersen & Co. in which I am a tax partner and head of our subchapter S tax specialty team. We endorse the bill. My comments will be directed principally to areas where we would like to see changes made rather than those areas we support.

One area that has not been mentioned is not in the bill; the dual application of the at-risk rules to both the corporation and its shareholders denies the investment tax credit in some very legitimate situations which our written statement explains in more detail. We would like to see some consideration of that.

On the toll charge or other view of a tax on the election, we believe that this is too broad a principle, since the perceived abuse is a corporation that might sell its operating assets and maintain its status as an investment company. We propose a specific rule to you today, whereby there would be a limited look-back, and retroactive termination and taxation as a personal holding company, and not snare a broad number of companies that are not actually out to try to abuse anything.

The section 385 issue; the same comment as virtually everyone else has made. The problem just really isn't there for a subchapter S corporation, and the abuse possibilities don't exist. We strongly recommend section 385 not be applied in a way that would terminate an election.

We think the foreign gross receipts limitation should be removed. We see no reason why a subchapter S corporation could not own a DISC or a foreign subsidiary for the same reason.

We think that an election, when timely made, should not necessarily require timely consents of the shareholders. There are adequate provisions in the regulations right now for bona fide consent extensions, where there is good reason, and we would like to see that continued.

We think the passive investment income limitation should be removed for much the same reason as what we said before. I think we can deal with the specific true possibilities for abuse without trying to catch everybody.

The inadvertent termination rules are good, but without more specificity, they are not going to be very useful until there are regulations. We would like to see the bill contain something more specific, or in the alternative, if it is possible, direct that guidance be issued by the IRS and Treasury very quickly.

We suggest that debt guaranteed by the shareholders be included in their basis. The current rule often requires some very artificial financing techniques to try to get the debt run through the shareholders, where in fact it really does not make any sense.

Chairman **Stark**. Mr. Thomas, let me interrupt. In the State of California, for all practical purposes, there is no personal liability on real estate loans, although you can guarantee one. How would you deal with that situation?

Mr. THOMAS. Many States do permit nonrecourse debt on real estate. The individual guarantee there would be, I think, academic, and no basis should be created by just artificially guaranteeing something. In the first place, I would not recommend to too many clients that they do that from a business standpoint. In very many cases the lenders say: Look, we want your names on this paper too; and the stockholders are just as liable as if they had borrowed the money directly.

Chairman STARK. Thank you.

Mr. THOMAS. The proposals on basis adjustments with respect to timing and coordination with distributions are not quite clear enough, and we think there are cases where an ordinary, timely distribution of current income might generate a gain where it really should not, and we would like to see clarification there.

We think the foreign loss recapture rule is too stringent, particularly at the time of the election.

With respect to the continuation of a fiscal year by an existing subchapter S corporation, if the 50 percent stockholder change is going to remain, we would like to see a time limit put on that. We have suggested a rolling 3-year period.

We think certain family gifts and redemptions under shareholders agreements should be excluded from the newly owned stock category, where they are legitimate transactions to protect the business and the continuity of the business.

The bill places a new time limit on distributions of previously taxed income from taxable years prior to the enactment date, and that is contrary to the existing law in section 1375(d). There are some real limits, some real restrictions that prevent companies from distributing those earnings, and imposing an artificial 14½ month period of time is not necessarily going to create the cash, and we would like to see some consideration given to that.

We believe the rule treating the election as a transfer of proven oil and gas properties is overly tough, and would like to see some changes there by a basis adjustment that would prevent getting depletion on such properties out tax-free.

The final specific point I mention orally, is that with respect to the cash basis treatment of payments to shareholders. That limitation should be increased to at least 10 percent to avoid hitting the legitimate case of the key employee who has a small stock ownership interest as an incentive and is truly not in any position to influence corporate activity or take the benefit of any abusive use of section 267.

Overall, we are very much in support of this bill. We think it is badly needed legislation. We also, though, are interested in one that is at the same time fair and equitable to the taxpayers and the people that have to live with this thing day by day, and interpret it and work with it without getting into trouble without knowing it.

Thank you, sir.

[The prepared statement follows:]

STATEMENT OF RICHARD L. THOMAS, ARTHUR ANDERSEN & CO.

SUMMARY OF SIGNIFICANT POINTS

A. Areas not covered by H.R. 6055

1. Investment Tax Credit - At Risk Rules

The application of the at risk rules to the investment tax credit will deny the credit to shareholders of an S corporation in certain cases where they are economically at risk.

2. Non-Refundable Credits Offsetting The Alternative Minimum Tax

Existing law on the offset of the Alternative Minimum Tax by certain non-refundable credits provides no guidance for shareholders of S corporations. Conflicting opinions indicate that clarifying legislation is required.

B. Areas on Which Comments are Requested by Sponsors of H.R. 6055

1. Tax Impact of an S Corporation Election on Shareholders

The sponsors of the proposed legislation are concerned that an S corporation election may be a tax avoidance opportunity to be corrected by a tax at the time of the election. This is not consistent with the intent of Subchapter S and would automatically eliminate Subchapter S as an option for many qualified corporations.

2. Debt/Equity Regulations and Single Class of Stock

The Section 385 regulations should not be applied to S corporations in a manner that would terminate the election. The debt/equity relationship is not a major problem.

3. Foreign Gross Receipts Limitation

The foreign gross receipts limitation should be eliminated. There is no practical reason for it; tax abuse possibilities are covered in Subchapter N.

C. Specific Provisions of the Bill

1. Ineligible Corporations - Section 1361(b)(2)

An S corporation should be permitted to own a DISC or a foreign subsidiary. There is little or no potential for tax abuse.

2. Filing of Shareholder Consents - Section 1362(b)(2)(B)(ii)

   An extension of time to file consents by shareholders of an electing corporation should be allowed without deferring the effective date of the election until the following taxable year.

3. Passive Investment Income Limitation - Section 1362(d)(3)(A)

   The passive investment income limitation should be eliminated. Specific provisions should be drafted for a corporation selling operating assets and remaining in existence as an investment vehicle.

4. Inadvertent Termination - Section 1362(f)

   The proposal for continuation of the election following an inadvertent termination is too uncertain. The provisions should be more specific.

5. Basis in Shareholders' Investment - Section 1366(d)(1)(B)

   Corporate debt guaranteed by the shareholders by requirement of the lender should be included in basis for the limitation on deduction of losses.

6. Distributions and Adjustments to Basis - Sections 1367 and 1368

   The proposals are not clear on the timing of basis adjustments with respect to distributions. The language should be specific to prevent misunderstanding.

7. Foreign Loss Recapture - Section 1373(b)

   The foreign loss recapture rule is too harsh.

8. Changes in Stock Ownership - Section 1378(c)(1)

   The provisions restricting changes of stock ownership as a condition to continuing use of a fiscal year should have a time measurement limit of three years.

9. Newly Owned Stock - Section 1378(c)(2) and (3)

   The change of ownership rules should not apply to certain family gifts and redemptions.

10. Distribution of Previously Taxed Income - Section 1379(c)(1)

    The proposals place a new time limit for distribution of Previously Taxed Income from preenactment taxable years. This seems unreasonable and is probably unintended.

11. Effect of Election on Depletion - Bill Section 3(a)

    Treating an election as a transfer of proven oil and gas properties, thus denying future percentage depletion deductions to the shareholders, strikes against the basic rule exempting from the transfer rules a mere change in business form with no change in ownership ratios.

12. Payments to Shareholders - Bill Section 3(g)(2)

    The limitation should apply only to a 10% or greater shareholder interest.

My name is Richard L. Thomas. I am a tax partner, Head of the Subchapter S Tax Specialty Team, for Arthur Andersen & Co. We welcome the opportunity to testify before this subcommittee today on the subject of the proposed "Subchapter S Revision Act of 1982."

The Arthur Andersen world wide organization conducts an international accounting practice. We have many clients that will be affected by the proposals; however, we do not represent them in this testimony and the views expressed are those of the Firm itself.

The original intent of Subchapter S, when enacted in 1958, was to permit taxpayers to select a form of business entity with reasonable independence of Federal income tax consequences. There are many non-tax legal and business considerations that may dictate the corporate form of doing business even though a partnership is preferable for Federal income tax purposes. The provisions of Subchapter S and subsequent amendments have gone part way toward achieving the original goal. H.R. 6055 is a giant step, however, and we are pleased with the overall intent of the Bill and support early consideration and passage.

There are a number of areas where we believe improvements can be made, and will address our comments accordingly.

There are several areas not covered in the Bill that we believe should be addressed and clarified.

Investment Tax Credit-At Risk Rules

The Economic Recovery Tax Act of 1981 extended the at risk rules of Section 465 to the investment tax credit (ITC). The application of the rules at both the Subchapter S corporation and shareholder levels will result in permanent loss of the ITC by shareholders of Subchapter S corporations in certain instances, and deferral in others. In either case, there is a punitive result not applicable to other taxpayers.

There is no "attribution" of at risk basis from a Subchapter S corporation to its shareholders under the general rule; a corporation may be at risk and qualify for the ITC, but the shareholders would be denied the credit because they have little or no basis in stock or debt, for whatever reason. If the corporation is at risk because of recourse financing from a qualified lender, the shareholders may eventually be able to claim the ITC as the debt is repaid. The cash used to pay the debt would presumably prevent distribution of earnings, increasing stock basis under Section 1376(a). This should be the effect of Section 46(c)(9).

The problem is illustrated by the following example:

A profitable corporation distributes all of its taxable income in cash each year. The shareholders have a zero basis in their stock.

1) The corporation purchases qualifying property with qualifying recourse debt. Annual ACRS deductions will exceed principal payments on the debt, but the resulting cash reserve will be retained for debt retirement.
   a) The corporation is at risk under Section 48(c)(8)(B)(i).
   b) The shareholders have no at risk basis.
   c) The shareholders will never be able to claim any ITC if the corporation continues to distribute its taxable income each year or terminates its Subchapter S election, unless Section 46(c)(9)(B) is amended to "impute" to the shareholders the increase in basis due to debt repayment.

(Note: If the debt were nonrecourse, the answer would be different for the corporation, but not for the shareholders.)

2) The corporation purchases qualifying property with cash accumulated in years prior to the Subchapter S election.

   a) The corporation is at risk.
   b) The shareholders are not at risk and will never be entitled to claim any ITC unless the corporation

retains enough Undistributed Taxable Income (UTI) to absorb the credit in the year of acquisition and/or succeeding years.

The answers would be the same if the corporation qualifies under Section 48(c)(8)(B)(ii), with no change in shareholder basis. Also, if the shareholders were to qualify for ITC in the future, under Section 46(c)(9), the maximum ultimately available would be limited to 80% of the total. If the shareholder does not meet the 20% at risk requirement in the year of acquisition, there is no way to make that up in the future through increases in basis of stock or debt.

Retention of UTI solely in order to claim ITC, assuming the Subchapter S election remains in effect, defers the benefit of the ITC until that retained income can be distributed after the end of the recapture period for the property. There is no comparable penalty for individuals or partners in partnerships because qualifying debt is part of their at risk basis and nonrecourse debt becomes so as it is repaid.

We recommend that H.R. 6055 include the necessary amendments to Section 46(c)(8) and (9) to eliminate the inequitable treatment of Subchapter S corporations and shareholders. This inequity has been acknowledged to a limited extent in H.R. 6414, introduced May 19, 1982. Representative Conable's remarks acknowledge the broader problem, however, whereby legitimate, active businesses are snared in the net cast over certain tax shelter abuses. There is no justification for the application of the at risk rules to an S corporation and its shareholders.

Non-Refundable Credits Available To Offset The Alternative Minimum Tax

Section 57(c)(2) [55(c)(2)] prescribes rules for the use of certain non-refundable tax credits against the alternative minimum tax. These credits must be directly connected with an active trade or business of the taxpayer, and there is no clear definition of whether the trade or business of a Subchapter S corporation is imputed to its shareholders. There is substantial authority under existing law to support a conclusion that the trade or business of a Subchapter S corporation is not imputed to its shareholders. The provisions of proposed Section 1366(b), and the overall intent of bringing the Subchapter S provisions more closely in line with those applicable to partnerships, indicate an intent to impute the trade or business activity of an S corporation to its shareholders when that is important for Federal income tax purposes. We recommend specific language to that effect be incorporated in H.R. 6055 and that it apply beginning with the effective date of Section 57(c)(2) [55(c)(2)].

Self-Employment Income

We recommend that a shareholder of an S corporation be treated the same as a limited partner in a partnership for purposes of net earnings from self-employment under Section 1402(a). This would require an addition to Section 1402(a)(12), or in the alternative an additional provision under Section 1402(a).

The sponsors of H.R. 6055 have requested comments on three areas not addressed in the Bill.

Tax impact of a Subchapter S election on shareholders

The question is whether an S corporation election by an existing corporation should, in effect, be treated as a liquidation of the corporation. Making the election is compared to a corporation that actually "converts" itself to a partnership, which requires an actual liquidation of the corporation, bringing into effect all of the applicable rules of Subchapter C. We are opposed to any such provision for the following reasons:

1. The question seems to presume an inherent tax avoidance motive for an election, which is inconsistent with original Congressional intent for Subchapter S. The complexity and hidden traps in the existing provisions of Subchapter S have been strong deterrents to election in many cases; inadvertent action, or inaction, could terminate an election, yet that termination could lie undiscovered for several years during which operations and distributions continued on the premise the corporation still qualified.
2. No existing corporation with significant fair market value would elect. A corporation with either an operating history or accumulation of assets that has generated significant value, or a corporation formed only recently but owning assets with high value in relation to tax basis, could not afford to elect S corporation status

regardless of the desirability of that form of operation. The shareholders would be taxed on a significant gain from which no cash or other funds are generated or otherwise available to pay the resulting taxes.

3. The election itself does not change the corporate structure or ownership of assets. An electing corporation would continue to be subject to the collapsible corporation rules of Section 341, all rules of recapture, etc.. We see no potential for tax abuse by an existing company that elects S corporation status and continues its activities as before.

4. There is apparent concern that an S corporation election may permit an operating company to sell its assets (in which it may have a high tax basis), and retain the proceeds within the corporation rather than liquidating. We believe this problem can be addressed satisfactorily without imposing the costly burden of treating an S corporation election as a de facto liquidation; we will cover this point specifically in our discussion of the passive investment income limitation.

The Debt/Equity Regulations and the Single Class of Stock

The regulations under Section 385 will apply to debt instruments created on or after July 1, 1982, and will require the treatment of certain debt instruments as preferred stock for all purposes of the Internal Revenue Code. This treatment for an S corporation would automatically cause termination of the election under existing Section 1371(a)(4) and proposed Section 1361(b)(1)(D). Debt instruments that meet the safe harbor requirements of the Section 385 regulations would cause no problem, but we believe there is no sound tax reason for leaving any uncertainty with respect to debt/equity treatment of shareholder debt and S corporations. The legislation should make it clear that characterization of debt as stock under Section 385 will not terminate an S corporation election.

The original intent of Section 385 was to provide objective standards to govern the "thin corporation" issue whereby profits or capital distributions to shareholders might be made under the guise of deductible interest (or a nontaxable repayment of principal) on amounts that actually should be considered equity. There is no potential for such tax abuse by an S corporation. All income is taxable to the shareholders regardless of whether it might or might not be called interest on debt; classification of amounts paid as interest or dividends is largely academic. This matter has been addressed in detail in several court decisions, primarily Portage Plastics Co. Inc., 486 F. 2d 632; Amory Cotton Oil Co., 468 F. 2d 1046; and Shores Realty Co., Inc., 468 F. 2d 572. In each case, the court found that classification as debt or equity was not important to the Subchapter S qualification of the corporation. We believe the provisions of proposed Section 1366(e) that require reasonable compensation for the use of capital will cover any potential abuse that might be available by use of debt to shift income among family members.

We agree with the single class of stock requirement for an S corporation. The limitation was designed to eliminate the complexity that might exist with respect to income allocation between or among different classes of stock and shareholders. We believe the rules that would be required to cover situations where more than one class of stock was outstanding would be unduly complex, and add to taxpayer misunderstanding and enforcement burdens.

Limitation on Foreign Gross Receipts

Present law provides that a Subchapter S corporation cannot receive more than 80% of its gross receipts from sources without the United States. We see no reason to continue this limitation. The provisions of Subchapter N, and particularly Subpart F, were designed to block opportunities for tax avoidance through overseas operations. An S corporation would be subject to all of the provisions of Subchapter N and we see no additional potential for tax avoidance.

The following comments relate to specific provisions of the Internal Revenue Code proposed in Section 2 of the Bill:

Ineligible Corporations - Section 1361(b)(2)

Existing Section 1371 permits a Subchapter S corporation to own a foreign subsidiary or a Domestic International Sales Corporation (DISC). The Internal Revenue Service has recently given specific approval to ownership of a DISC by a Subchapter S corporation in Private Letter Ruling 8211116. Accordingly we recommend that the phrase "without regard to the exceptions contained in subsection (b) thereof, " be eliminated from proposed Section 1361(b)(2)(A). This recommendation is consistent with our suggestion that the foreign gross receipts limitation be removed from the law; an electing S corporation would, as previously stated, be subject to all of the provisions of Subchapter N, and specifically Subpart F with respect to controlled foreign corporations.

Banks and insurance companies are treated as ineligible corporations. Certain state and federal regulatory rules may prohibit operation of a bank or an insurance company in S corporation form, but we believe such entities should be allowed to choose S corporation status if it is permissible under applicable state and federal regulations. There is no unique opportunity for tax avoidance by either type of entity.

Filing of Shareholder Consents - Section 1362(b)(2)(B)(ii)

Existing Regulation 1.1372-3(c) permits an extension of time for filing of shareholder consents where reasonable cause is shown for the failure to file such consents on a timely basis. We recommend that this provision of the proposal be changed to make it clear that an extension is possible under the same conditions stated in the existing regulations, and that under those circumstances an otherwise timely election will be effective for the taxable year in which it is made rather than for the next taxable year.

Revocation of Election - Section 1362(d)(1)(B)

The heading "One-half of Shareholders Must Consent to Revocation" is in error. Under the proposal, consent is required by shareholders owning more than one-half of the shares of the corporation's stock. To avoid a heading of equal length to the provision itself, we suggest the heading be changed to, "Required Shareholder Consent to Revocation."

Passive Investment Income Limitation - Section 1362(d)(3)(A)

The existing passive investment income limitation would be retained for an S corporation having accumulated earnings and profits at the close of a taxable year in which passive investment income exceeds 20% of the gross receipts. We understand the intent of this provision is to prohibit:

1. a corporation from electing S corporation status, selling its assets, passing a lower gain through to the shareholders, and then remaining in existence as an investment company, when it has a relatively high basis in its assets compared to the shareholders' basis in their stock.
2. an existing personal holding company from electing S corporation status.

We believe the potential impact of this provision extends far beyond such situations. The passive investment income limitation would continue to be applicable to almost every Subchapter S corporation in existence prior to the effective date of the Bill, or to any regular corporation which elects S corporation status after the effective date of the new Bill. Outside of the concerns mentioned above, there is no reason for continuation of the passive investment income limitation; the complete pass through of all items of income and expense to the shareholders and the removal of the distinction between earned and unearned income (enacted in 1981) for individual tax purposes eliminates any possibility for unintended benefit.

To treat the specific situation of corporations that sell appreciated operating assets and remain as investment vehicles, we recommend that specific language be included to apply to such corporations, as follows:

1. The provisions would apply to any S corporation having accumulated earnings and profits that sells all or substantially all of its operating assets, and which
2. During the three taxable years following the year of such sale, has more than 80% of its total gross receipts from passive investment income.
3. The election would be terminated as of the beginning of the taxable year in which the sale occurred, and the corporation would be classified as a personal holding company, and taxed accordingly.
4. The statute of limitations will be extended and consistent reporting requirements will be included.

We also recommend that the definition of passive investment income be changed to provide the same exceptions for rent as those in the personal holding company rules and to codify the "significant services" exception of Regulation 1.1372-4(b)(5)(vi).

We believe these changes would prevent the perceived possibilities for abuse, while at the same time recognize that a company may decide to sell the assets used in its existing business and enter a new one. The three year "grace" period would provide reasonable time between the sale and active operation of the new business to allow for delays in acquiring the assets to be used in the new business, lack of operating income during the start-up period, etc.

We see no reason why an existing personal holding company should be denied S corporation status. The passive investment income limitation has been almost unanimously criticized since 1958. The personal holding company rules were designed to prevent sheltering investment income at lower corporate tax rates. A personal holding company could not make tax-free distributions of previously accumulated income under the proposals, and the shareholders would be required to report all income subsequent to the election. That seems consistent with the above intent.

Inadvertent Termination - Section 1362(f)

The Bill would give the Secretary the discretion to determine whether a termination under proposed Section 1362(d)(2), (3) or (4) was inadvertent, permitting the corporation to continue the election. We believe this language is too subjective, and will eliminate any use of this provision until regulations are prescribed to set forth the conditions under which a termination will be considered inadvertent. We recommend that specific guidance be given the Secretary, and taxpayers, or that specific description of conditions under which a termination will be considered inadvertent be included in the Bill.

In the absence of specificity, a corporation undergoing a termination would be forced to operate under the assumption that it was no longer a qualifying S corporation until such time as the determination were made. This might impose a severe hardship on shareholders by preventing definite planning for their personal tax situations during the intervening period. Attention to possible application of the mitigation rules would also be necessary. If the passive income and foreign gross receipts limitations are removed as we have suggested, we believe sufficient guidance exists in private letter rulings issued under existing Section 1372(f) for specific rules that might be incorporated in the Bill.

Basis in Shareholders' Investment - Section 1366(d)(1)(B)

Many legitimate financing transactions involve the advance of credit by an unrelated third party lender to an S corporation, with that debt guaranteed by the shareholders. The shareholder guarantee is required by the lender as a condition for making the loan. Under both existing Subchapter S law and the Bill, debt guaranteed by shareholders is not included in tax basis to determine the limitation on deduction of losses. It is true that the shareholders have not yet made an out-of-pocket investment equal to their liability, but it is equally true they bear the economic burden of the obligation, i.e., they are "at risk", until it is retired by the corporation or they are called upon under the guarantee. In a partnership, on the other hand, a general or limited partner is entitled to include in basis the amount of outside debt for which he may have personal liability either through operation of law or by individual assumption. The unlimited carryover of disallowed losses and deductions provided by proposed Section 1366(d)(2) will probably allow the shareholders eventual deduction of the loss, but we believe that in keeping with the overall intent to more closely parallel partnership treatment, the shareholders should be allowed to claim the deduction currently where they have personal liability for obligations of the corporation.

We recommend that provisions similar to those in Subchapter K be included to permit the addition of guaranteed debt to basis for this purpose, and to treat repayment of that debt by the corporation as a constructive cash distribution to the shareholders.

Distributions and Adjustments to Basis - Sections 1367 and 1368

The Bill is not clear on the interrelationship between distributions under proposed Sections 1363(d)(1) and 1368(b) and (c) and adjustments to basis under proposed Section 1367. Adjustments to basis ordinarily can be made only after the end of the S corporation's taxable year when all necessary information is available to determine each shareholder's income or loss under proposed Section 1366. A distribution to a shareholder during an S corporation taxable year would always be in excess of basis at the date of distribution, resulting in gain under proposed Section 1368(b)(2), if the shareholder's basis in stock were zero, even though current year's earnings were the source of the distribution.

The treatment of distributions of current income, which would be from current earnings and profits under existing law, should be clearly defined. We recommend that proposed Section 1368(d) be clarified to state that adjustments to basis and the accumulated adjustment account for any S corporation taxable year will be made before determining the effect of distributions under proposed Section

1368(b) or (c). This is consistent with the provisions of Regulation 1.731-1(a)(1)(ii) with respect to distributions of current income by a partnership.

Foreign Loss Recapture - Section 1373(b)

A corporation would be required to report as taxable income any previous overall foreign loss either upon making an election or terminating an existing election.

We believe this provision is unduly harsh. An S corporation election should not cause recognition of income not yet realized. The provisions of existing Section 904(f) should continue to be applicable to the corporation, and foreign source income treated as income from sources within the United States for purposes of the foreign tax credit, as originally intended.

The provision for recapture upon termination of an S corporation election may be appropriate, but only to the extent the shareholders have received the benefit of a deduction for foreign losses on their individual returns.

Post-Termination Transition Period - Section 1377(b)(1)(A)(ii)

We believe the last word in this sentence should be "or" rather than "and". It appears the 120 day period following determination that the corporation's election has terminated is an alternative to the period specified in subparagraph (A).

Changes in Stock Ownership - Section 1378(c)(1)

The unlimited period for measurement of a cumulative change of ownership of more than 50% seems unreasonable. We recommend limitation to a cumulative change of ownership during a period of any three consecutive taxable years, beginning with the first taxable year following the taxable year that includes December 31, 1982. This is consistent with other provisions of the Internal Revenue Code that prescribe certain limitations, etc., following a stipulated change in ownership, such as existing Section 382(a)(1)(A) or Section 708(b)(1)(B). Note that similar rules for taxable years for partnerships were included in the Internal Revenue Code of 1954, with a provision that existing partnerships reporting on a fiscal year could continue to use that fiscal year until a termination occurred under Section 708. We do not believe it is unreasonable to prescribe a three year time limit for the change in ownership.

Newly Owned Stock - Section 1378(c)(2) and (3)

A change in ownership of an S corporation by gifts of stock by existing shareholders to a family member or redemption from a shareholder would be "Newly Owned Stock" under the Bill. We recommend exemption of a gift or of a redemption under the provisions of a shareholders' agreement that provides for redemption of stock when a shareholder leaves the employ of the corporation, retires or dies. Agreements with provisions for redemption under the above conditions are generally advisable for closely held corporations, regardless of whether they are S corporations. We believe a change of ownership as a result of the type of redemption that protects the ongoing business should be excluded from these rules.

We also suggest that specific language be included to state that a transfer by reason of death will also include a transfer to a testamentary trust and the subsequent transfer of the stock by the trust to its beneficiary(ies).

Distribution of Previously Taxed Income - Section 1379(c)(1)

Under existing law, Previously Taxed Income (PTI) can be distributed to the shareholders free of additional tax during any succeeding taxable year covered by the election. A distribution of PTI comes before any distribution of an ordinary dividend from accumulated earnings and profits, and there is no time limit.

The Bill, however, would require distribution of PTI from preenactment taxable years no later than two and one-half months following the close of the first postenactment taxable year. For an S corporation with accumulated earnings and profits, failure to make the distribution within that restricted time period would require distribution of any accumulated earnings and profits as an ordinary dividend before a nontaxable distribution of PTI could be made. We believe this is unintended, and unreasonably harsh. There is no incentive, tax or otherwise, for an S corporation to withhold distributions of PTI.

Accumulation of PTI is caused by cash shortages, loan restrictions, or other business conditions preventing distribution. The limitations are likely to continue in many cases, and there is no reason to place a new restriction on such distributions.

This suggestion will require an additional "tier" in proposed Section 1368(c), and it should be inserted following paragraph (1) as new paragraph (2). The language should be basically the same as that in existing Section 1375(d).

Bill Section 3

Effect of Election on Depletion - Section 3(a)

An S corporation election by a regular corporation would be considered a transfer of proven oil and gas properties, denying to the shareholders the deduction for percentage depletion under the independent producer exemption.

Under existing law, the deduction for percentage depletion in excess of cost is an adjustment to earnings and profits of a corporation. The cash represented by a percentage depletion deduction cannot be distributed tax-free by a Subchapter S corporation; it is a distribution of a dividend from earnings and profits. A corporation that owns proven oil and gas properties might make an election in order to permit a nontaxable distribution of the depletion deduction to its shareholders in the absence of some restrictions. Treating the election as a transfer, however, as under the Bill, seems unnecessarily harsh. We suggest the definition of the "Accumulated Adjustment Account" in proposed Section 1368(e)(1)(A) be changed to provide for reduction of the account by the percentage depletion deduction claimed by a shareholder with respect to proven oil or gas properties owned by the corporation at the date of the election.

Payments to Shareholders - Section 3(g)(2)

An S corporation would effectively be placed on the cash basis for any amount paid or incurred to a shareholder who owns more than 2% of the outstanding stock, directly or indirectly, if the amount would not be includable in the recipient's income in the same year it would otherwise be deducted by the corporation. We recommend the 2% ownership limit be increased to at least 10%. There are many cases where a key employee who is not related to the major shareholders acquires a stock ownership interest in the corporation as an incentive. Such individuals usually have little voice in shareholder affairs unless their ownership increases to or above the 10% level, and we do not believe the potential for tax abuse under Section 267 is very great with respect to shareholders owning less than 10% of the stock.

We would like to thank you for the opportunity to testify at this hearing. We urge the subcommittee to consider our recommendations before completing action on this important legislation. We will be happy to answer any questions that members of the subcommittee or its staff may have concerning our comments and recommendations, or to furnish any additional information requested.

Chairman STARK. Thank you, Mr. Thomas.
Mr. Alexander.

STATEMENT OF DONALD C. ALEXANDER, MEMBER, TAXATION COMMITTEE, CHAMBER OF COMMERCE OF THE UNITED STATES

Mr. ALEXANDER. Mr. Chairman, I am Donald Alexander, appearing here today for the people that do have to live with this bill, the over 200,000 small businesses that belong to the U.S. Chamber of Commerce. With me is David Franasiak, the director of the chamber's tax policy center.

These people that are going to have to live with this bill, Mr. Chairman, are not people that can afford to pay the fees of the eloquent representatives you have heard from the Bar Association and the top people in the major accounting firms, and that is the problem. The bill itself represents an excellent step forward towards some long-needed improvements in subchapter S. I have been working in this area since 1965, and I am delighted to see this bill move, and I congratulate the committee for moving it and the subcommittee for having these hearings.

One of the issues before you is whether the old passive income test in subchapter S should be continued at all and if so, to what extent.

All the witnesses I think thus far have agreed that the passive income test, a test based on a percentage of gross receipts of a business, and whether rents constitute active rents or passive rents and whether interest is active interest or passive interest, has no business in subchapter S.

It is eliminated under the bill, but only to a limited extent. The elimination applies to companies that elect subchapter S status upon incorporation, or when they do not have earnings and profits, but not to companies that have earnings and profits. The problem there, Mr. Chairman, that a lot of companies do not know whether they have earnings and profits or whether they do not. I am surprised to find in testimony produced to this committee this issue glossed over, with a suggestion that earnings and profits for tax purposes are easily determinable or they approximate the excess of book basis over equity capital. They do not, and they won't in the future, as section 312(k) of the Code goes into effect. People do not know that they have earnings and profits, and if they do not know that, they do not know how much the earnings are so they won't know how much to purge if they did think they had some earnings, and a lot of people have guessed wrong under a similar provision of the Code, section 333, to their great detriment.

We start with the suggestive solution of retrimming the passive income test that I think most have some concern about, having made the assumption that there is some sort of abuse out there that we have to cope with. What is that abuse? You put your finger on it earlier, Mr. Chairman. Maybe it is a function of size. If a business had $10 in accumulated earnings and profits, and about $50,000 in aggregate assets, it is hard to say what great inroads would be made on our tax system if that business were permitted to elect subchapter S without any toll charge, even the minor toll charge that would be imposed on that $10. Where is the abuse?

If there is a need for the passive income test, isn't the first problem some concern about the size of incorporated pocketbooks? But someone could inherit a very large amount of income-producing passive assets and put them in a new subchapter S corporation without fear of the proposed toll charge or of the requirement of a passive income test.

Now, a toll charge upon election of subchapter S status by a subchapter C corporation will come as sort of a surprise, if you decide to enact it, and I surely hope you don't. It would be something new in the law. Right now companies can become S corporations without a toll charge, and under this bill as you propose it, some companies that are ineligible would be permitted to elect, but they would suddenly find that there was a toll charge upon their election that wasn't present last year.

Second, it has been suggested somehow that this toll charge is a step in the direction of simplification. Mr. Chairman, the type of toll charge that you would have to enact to prevent massive tax evadance and still not make it so high that people go into subchapter S, represents simplicity about as much as I resemble Bo Derek.

Chairman **Stark**. You made your point.

Mr. **Alexander**. I am sorry that my lack of resemblance to Bo Derek is that obvious.

Let us go into the bail-out problem. Mr. Glickman mentioned it and you did, too. Suppose you put on a toll charge, and let's make it 20 percent a year for 5 years, and let's say at the end of that period you can go back to subchapter C status, build up a lot of earnings, be free of section 531 fears—that is one of the gimmicks of those proposals—and strip those earnings at a 20-percent tax rate again for 5 years.

What you would have done is undermine our present unintegrated corporate tax, which is the excuse, Mr. Chairman, for the toll charge proposal in the first place. It doesn't make sense. Retention of passive income doesn't make sense. The problems created by this gimmick on your proposal are vastly out of proportion to the "abuse" that the proposal is attempting to dispose of.

What that abuse is, and Mr. Glickman made it clear, and another witness, Mr. Shaw, has made it clear, the "abuse" is the step up at death, section 1014. If that is an abuse, Congress decided that it wasn't in 1980, and there is no reason whatever to have a selective solution to that so-called abuse applied only to subchapter S corporations.

[The prepared statement follows:]

STATEMENT OF DONALD C. ALEXANDER, FOR THE CHAMBER OF COMMERCE OF THE UNITED STATES

My name is Donald C. Alexander. I am a member of the Taxation Committee of the Chamber of Commerce of the United States, on whose behalf I am appearing today. I am a member of the law firm of Morgan, Lewis & Bockius, of Washington, D.C. I am accompanied today by David E. Franasiak, Director of the Chamber's Tax Policy Center. On behalf of the Chamber of Commerce of the United States, representing over 240,000 business, trade association, and local and state chamber members, we welcome the opportunity to support the broad objectives of H.R. 6055, the Subchapter S Revision Act of 1982.

The Subcommittee on Select Revenue Measures has specifically invited comment on the proper treatment of regular corporations electing Subchapter S. This includes the issues of whether the passive income limitation under current law should be retained and whether there should be a "toll charge" or similar exaction upon the conversion of a regular corporation to Subchapter S status. Comment is also requested on the retention of the prohibition in present law against a second class of stock and present law's limitation upon foreign income. This statement addresses the first two issues and other questions of direct impact upon small business.

Introduction

The Chamber commends Chairman Stark, Chairman Rostenkowski, Representative Conable and the Committee for their effort to simplify and improve Subchapter S for small business. Over 90% of our business members employ fewer than 500 people and over 60% employ fewer than 20 people. These small businesses would greatly benefit from improved Subchapter S provisions. H.R. 6055 would make substantial headway towards achieving that goal. By easing the eligibility rules for Subchapter S election, eliminating certain traps, and improving the rules for passthrough of losses and various types of income, H.R. 6055 will have a broad beneficial effect on small business.

However, in its present form, the bill would not remove the passive income test for companies with accumulated earnings and profits making a Subchapter S election, thus continuing one of the most troublesome provisions in present Subchapter S. This serves no real revenue purpose and inhibits the use of Subchapter S by the small businesses it was intended to serve. The passive income test should be eliminated entirely. Furthermore, no "toll charge" or other penalty should be imposed on regular corporations which make a Subchapter S election.

I. Passive Income Test

Under H.R. 6055, the passive income test is eliminated except for companies which make the Subchapter S election when they have some earnings and profits accumulated from prior years. In order to evaluate this issue properly, it is first necessary to review the passive income test and the problems that it has created in the past and will continue to create in the future if retained to any extent. The second issue is to determine what purpose will be served by the retention of the passive income test and whether these anticipated benefits outweigh the detriments created by its retention.

A. Present Law.

Under the passive income test of present Section 1372(e)(5), a Subchapter S election is terminated if more than 20% of the gross receipts of the electing corporation are rents, royalties, interest, dividends, annuities and sales or exchanges of stock or securities. This restriction is a trap for the unwary, has generated much litigation, and no longer serves any revenue purpose.

Many controversies have arisen about whether interest, rents, or other types of income earned in the active conduct of a trade or business are bad "passive" income or good "active" income.[1] Decided cases are, of course

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[1] See, for example, Marshall v. Commissioner, 510 F.2d 259 (10th Cir. 1975) aff'g 60 T.C. 242 (1973) (interest received by a corporation actively engaged in small loan business is passive income); and Zychinski v. Commissioner, 506 F.2d 637 (8th Cir. 1974), aff'g 60 T.C. 950 (1973) (gain on sale of securities by securities dealer actively engaged in trading stocks is passive income).

course, only the tip of the iceberg. Numerous inadvertant disqualifications have occurred, and the uncertainty of classification of income (e.g., "active" rents) and whether business factors and economic conditions may cause "passive" income to increase beyond the permissible level have had a serious adverse effect upon the use of Subchapter S by small businesses which it was intended to benefit.

B. Proposed Change.

The staff of the Joint Committee on Taxation recommended in their report on Subchapter S in May, 1980 that the passive income test be eliminated in order to reduce uncertainty as to whether certain types of income were covered by the limitation, to reduce litigation and to prevent retroactive termination of elections.

Elimination of the troublesome passive income test would not create a loophole or have unwarranted tax effects. As the Joint Committee staff pointed out, perhaps the principal reason for the inclusion of the test in 1958 was to prevent taxpayers from incorporating investment activities in order to obtain substantial benefits under qualified corporate retirement plans. This problem was resolved in 1969 when the strict limitations applicable to partners and sole proprietors were imposed upon stockholder-employees of Subchapter S corporations. These restrictions would be tightened under the proposed legislation.

Also, the removal of the differential between the top individual income tax rates upon investment income and those upon earned income eliminates any reason to use Subchapter S to try to convert investment income into earned income. Finally, the personal holding company provisions would not be vitiated by removal of the passive income test because the income of an electing corporation is taxed directly to its shareholders.

H.R. 6055 deletes the passive income test for S corporations with no accumulated earnings but retains the test, unaltered, for all other S corporations. Thus, the trap under present law would be continued for all corporations which retained earnings accumulated during the period of operation under Subchapter C. Corporations exempted from the harsh test would be those newly-incorporated under Subchapter S and those which either had no earnings or rid themselves of their earnings from operations prior to the Subchapter S election.

Many small corporations considering a Subchapter S election will have accumulated earnings but will not know it. The computation of earnings and profits is very difficult for even the most sophisticated corporation with the best records and advice; the problem is compounded for a small corporation which cannot afford such luxuries. Also, many owners of small corporations believe, erroneously, that earned surplus on their books equals earnings and profits for tax purposes. This is not the case, and the 1981 Economic Recovery Tax Act compounds the problem. New Code Section 312(k) requires a far different computation of capital cost allowances for earnings and profits purposes than that permitted for tax computation purposes. The existence of unknown accumulated earnings has proved to be a trap under Section 333 of the Code. This trap should bot be extended to Subchapter S unless there are compelling reasons for its extension.

Moreover, an existing corporation believing that it has significant earnings accumulated while operating under Subchapter C would be faced with a dilemma. Should it distribute earnings, thereby reducing its resources in an effort to purge itself, or run the risk of a termination of its Subchapter S election by reason of its inability to control the exact mix of future gross receipts? Furthermore, if it decided to rid itself of its earnings but distributed too little, it would avoid neither the present detriment nor the future danger.

It appears that retention of the passive income test may stem from a concern that its elimination might lead to use of an S corporation to avoid tax to its shareholders on previously-accumulated earnings. We do not believe that this concern has any foundation.

Under present law, both the shareholders of an S and a C corporation are subject to tax on dividends paid from accumulated earnings. Under H.R. 6055, these rules remain in effect. If such accumulated earnings are invested by a C corporation, the current income thus derived is subject to tax at corporate rates rather than the generally higher individual rates. In the case of an S corporation, such income is taxed to the shareholders at individual rates. The same result would follow under the bill.

The restoration of stepped-up basis in the event of death has been described as a potential for tax avoidance in the case of a C corporation with accumulated earnings electing Subchapter S treatment. When in 1980 Congress revised its 1976 action and restored stepped-up basis, it decided that corporate earnings realized by the shareholders may be freed of tax at the shareholder level if shares pass through an estate and the heirs sell or liquidate the corporation. Surely it was not intended to limit the benefit of stepped-up basis to Subchapter C corporations.

Why should a restriction be placed in Subchapter S to solve a problem (if it is a problem) created by the restoration of stepped-up basis? In this context the only advantage of electing Subchapter S status is to obtain pass-through treatment of interim corporate earnings awaiting the death of the shareholder. However, this ephemeral advantage is at odds with the purported motive for the election; the longer the interim benefit, the longer the delay until death completes the tax plan. Relieving distributed corporate earnings from shareholder tax is a function of Code Section 1014, not of Subchapter S. If the major concern centers on stepped-up basis, that issue should be addressed directly, not in the context of Subchapter S simplification.

In short, there is no justification for perpetuating the confusion and uncertainty caused by the passive income test. The intent of the bill is to simplify the operation of S corporations and ease the eligibility rules as to obtaining and preserving S corporation status. Elimination of the passive income test would greatly further these goals and would not promote tax avoidance.

II. Toll Charge

Comment has also been requested on the tax treatment of the election of Subchapter S status by Subchapter C corporations. Is the election tantamount to a liquidation and should it be considered a taxable event? Should some toll charge be imposed if the corporation making the election has accumulated earnings?

A toll charge on the conversion of a Subchapter C corporation to Subchapter S status is overkill. A major purpose of the bill, to treat Subchapter S corporations more like partnerships, does not mean that a C corporation converting to Subchapter S in fact or in effect liquidates into a partnership. The conversion is in no way equivalent to a liquidation; basis is not stepped up but instead carries over, earnings and profits carry over, and withdrawal of accumulated earnings and profits produces the same consequences as it does if the corporation had continued in Subchapter C status.

The fact that the character and tax treatment of future revenues from particular sources (e.g., natural resources) would be passed through to the stockholders of the Subchapter S corporation does not require the imposition of the wrong tax at the wrong time upon the wrong base. These considerations go only to the treatment of future revenues; the existence of past earnings is irrelevant. The bill wisely imposes no toll charge upon the act of electing. A mandatory charge would be a long step backward toward reducing the utility of Subchapter S.

Some have proposed an elective toll charge to purge the electing corporation of its previously-accumulated earnings at capital gains rates. The complexities and conditions required to protect the revenues against the use of such a device to effect a bailout of earnings would add substantially to the complexity of the Code and to the revenues of tax practitioners, but do little for small business. Without stringent restrictions and conditions, an elective toll charge would create a new loophole of enormous proportions. Moreover, an elective toll charge is not needed if, as we urge, the passive income test is removed for all corporations.

III. Election and Termination Provisions

Under current Section 1372(c), an election to be treated under Subchapter S must be made at any time during the preceding taxable year or during the first 75 days of the taxable year. Failure to comply with the 75-day requirement means that the election becomes effective for the following taxable year.

The Code provides no criteria for determining when a taxable year begins. However, Internal Revenue Service regulations provide that the first month of the first taxable year can be either when the corporation has shareholders, or when it acquires assets, or when it begins to do business, whichever occurs first. These somewhat loose criteria have caused problems for new Subchapter S corporations, for it is frequently difficult for a small corporation to be certain when any one of the above events has occurred.

We suggest that a further alternative be provided: a Subchapter S election should be considered valid if made within 2-1/2 months after the new corporation's charter or certificate of incorporation is filed. Owners of and advisors to small businesses know when the corporation comes into legal existence, and elections made with respect to this date, whether or not meeting the present tests in the regulations, should be valid.

Present law also limits the making of a voluntary revocation of an election. Small businessmen contemplating a Subchapter S election who do not have the resources for expert tax advice on the benefits and detriments of Subchapter S frequently discover within the first year of the elction that the decision to elect was ill-considered. Current law defers the effectiveness of a voluntary revocation of an election unless made during the first month of a year, but provides a means to terminate the election retroactively if one deliberately undertakes to violate one or more of the Subchapter S eligibility requirements.

H.R. 6055 modifies and improves current law by permitting a revocation to be made within the 15th day of the third month for any taxable year. However, revocations after that date are effective only for the following taxable year. We support the concept of expanding the opportunity to make a voluntary revocation and believe that electing shareholders should be permitted to revoke an election by the due date for the return for the first taxable year of operation under Subchapter S. Small businessmen should not be penalized because they have been unable to foresee all the consequences of Subchapter S. Moreover, retention of the 5-year ban on subsequent Subchapter S elections should prevent abuse.

IV. Conclusion

We support the broad objectives of H.R. 6055 and we would be happy to work with the Subcommittee and staff on the issues discussed above and other questions which may arise.

Chairman STARK. Thank you very much.

Professor Ginsburg, welcome back to the committee. Proceed. You may be the cause of all the controversy today.

STATEMENT OF MARTIN D. GINSBURG, PROFESSOR OF LAW, GEORGETOWN UNIVERSITY LAW CENTER

Mr. GINSBURG. I was reasonably happy, although to a small extent surprised, to discover the announcement of my parentage, but I will move forward nonetheless. I hope that at the end I will have a chance to respond to one or two of the comments of my good friend Donald Alexander nee Bo Derek.

I am Martin D. Ginsburg, professor of law at Georgetown University Center, where I teach subjects in the field of taxation. I am privileged to appear today, in individual capacity as distinguished from institutionally, on behalf of the committee on simplification of the section of taxation of the American Bar Association, of which committee I currently am vice chairman.

In introducing H.R. 6055, Chairman Rostentowski and Mr. Conable requested public comment on three main issues. The written statement I have submitted this morning on behalf of the simplification committee attempts to respond in our usual inordinate length and detail.

I should like to focus my attractively brief oral testimony on what seems to everyone today the most significant issue, the C to S problem, significant I believe because it is the key to resolving a number of the other important and troublesome questions in the area, to some of which I will refer in due course.

If we wrote today on a clean slate, I truly believe we could and would sensibly resolve the shift of status issue in a wholly simple and effective way and we would, I hope, adopt a uniform set of rules for all pass-through business entities, subchapter S corporations and partnerships alike. But to write on a clean slate, we would have to be sitting here, not today and not even in 1958 when subchapter S first was enacted, but rather in 1913 when we first embraced the tiny revenue act that started us down the slope to the great bog in which we now muck about.

In 1958, Congress did not declare that a C corporation must liquidate or must be treated for tax purposes as if it completely liquidated, in order to be reincarnated as an S corporation. And if that choice was not realistically available in 1958, certainly it is not realistically available today, almost a quarter of a century later, when we already have tens of thousands of S corporations that earlier shifted from C status.

The C to S problem is a very big problem because an extraordinary amount of what is complex and unsatisfactory in present law, and remains so in the bill, flows directly from an S corporation's subchapter C history, largely but not exclusively the preservation of its C history accumulated earnings and profits.

Included in the catalog of misfortune are, among other things, the passive gross receipts limitation, the proposal to tax the distribution of even long-term capital gain assets, a tax treatment wholly at odds with the bill's general passthrough approach, the special corporate level double tax now found in section 1378 on capital gains recognized in the first years following shift from C to S, the extraction of dividend tax on distributions out of tax exempt income, and some rather special problems involving the debt equity concern which the staff, toward the end of its excellent pamphlet, has focused.

Each of these special rules, or something like each of them, is appropriate if the S corporation retains accumulated earnings and profits. The tax world would be a vastly similar and better place if Congress were to provide a conceptually sound, practicable way to eliminate accumulated earnings and profits.

Not a mandatory toll charge to be shouldered by the shareholders of every S corporation that shifts from C status or ever did, no matter how long ago. Rather, an elective cleaning out of accumulated earnings and profits under a system sufficiently attractive and sensible, while at the same time protective of the revenue, that taxpayers in substantial numbers will choose it.

The proposal that we advance and that has been described in summary form by various witnesses this morning is a two-track subchapter S system. If the corporation and its shareholders choose what we call track 1, accumulated earnings and profits are washed away, and washed away with them are the passive gross receipts limitation, the section 1378 double tax on capital gains, the proposed immediate taxation of capital gain property distributions to shareholders, and all of those other special protective complexities of old and of the bill's proposed new law. But in return each shareholder incurs a potential toll charge.

In our proposed system, a toll charge at capital gain rates spread over 5 years and equal to the amount, if any, by which the shareholder's percentage of the corporation's net basis is in its assets—that is, the basis of the assets less the corporation's liabilties—exceeds the shareholder's basis in his shares. That differential approximates his share of accumulated earnings and profits and, where there are differences, for the reasons indicated in our written statement we believe the basis differential approach is the better one.

In no case under our proposal can the toll-charge capital gain exceed the gain the shareholder would recognize if he simply sold the shares, a limitation that insulates from tax, new purchasers of shares and, because share basis is stepped up at death, insulates as well the estate of a recently deceased shareholder. The 5-year spreadout would be subject to acceleration if the shareholder receives excessive distributions from the S corporation during that period or disposes of the shares other than by death.

Now, obviously this is a very attractive regime, withdrawal of all sorts of money at the cost of a limited capital gain tax and, as Mr. Alexander has suggested, it would prove far too attractive if the corporation reverts to C status too quickly following the selection and distribution. In our written submission, we have detailed a set of antibailout rules that come into play, if the double shift, C to S and then back to C status again, occurs within 5 years.

Chairman STARK. This is a single wing to the T formation.

Mr. GINSBURG. I have the feeling the chairman may have read our proposal.

The proposal would impose a dividend penalty in those double shift circumstances, but only on those shareholders who have both withdrawn excess money or property and are still living and are still shareholders when the inappropriate shift back to C status takes place.

If there is a concern, as has been expressed, that a 5-year rule will encouarge shifts in and shifts out of subchapter S every 5 years, something that I consider doubtful when I run the arithmetic, Congress need only declare that the C corporation cannot freely elect to go back to S status once again until, say, 10 years or any other time Congress sets. None of the toll charge antibailout rules, of course, will be of any concern or application to a new corporation that elects S status from the outset. It will have the benefit of track 1 at no cost at all.

Under the proposal, S corporations with C history that do not wish to trigger even a spread capital gain toll charge can avoid it merely by not electing track 1. Automatically, they will be on subchapter S, track 2, preserving accumulated earnings and profits and thereby remaining subject to the series of revenue protective rules and limitations and complexities this entails.

In sum, to expunge accumulated earnings and profits, which we believe is the key to truly simplifying subchapter S, we propose a carrot but not a stick, a choice that can be made but is not mandated when, for example, liquidity is an overwhelming problem. We believe, however, that track 1 will prove a very popular choice, and that while there will be many beneficiaries, the greatest will be the rationalized and in practice much simplified subchapter S taxing system.

[The prepared statement follows:]

STATEMENT OF MARTIN D. GINSBURG

MR. CHAIRMAN AND MEMBERS OF THE SUBCOMMITTEE:

MY NAME IS MARTIN D. GINSBURG. I AM A PROFESSOR OF LAW AT GEORGETOWN UNIVERSITY LAW CENTER WHERE I TEACH VARIOUS SUBJECTS IN THE FIELD OF FEDERAL TAXATION. FOR SOME TWENTY YEARS PRIOR TO BECOMING AN ACADEMIC, AND WITH A MORE MODEST TIME COMMITMENT SINCE, I HAVE PRACTICED LAW PRIMARILY IN THE FEDERAL TAX FIELD.

I AM PRIVILEGED TO APPEAR TODAY IN INDIVIDUAL CAPACITY, AS DISTINGUISHED FROM INSTITUTIONALLY, ON BEHALF OF THE COMMITTEE ON SIMPLIFICATION OF THE SECTION OF TAXATION OF THE AMERICAN BAR ASSOCIATION, OF WHICH COMMITTEE I CURRENTLY AM VICE-CHAIRMAN.

I AM VERY PLEASED TO TESTIFY THIS MORNING ON H.R. 6055, THE PROPOSED SUBCHAPTER S REVISION ACT OF 1982. IN HIS DETAILED AND INFORMATIVE FLOOR STATEMENT INTRODUCING THIS SIGNIFICANT LEGISLATION, CHAIRMAN ROSTENKOWSKI REQUESTED PUBLIC COMMENT ON THREE IMPORTANT ISSUES. FIRST, THE PROPER TREATMENT OF A REGULAR CORPORATION ELECTING SUBCHAPTER S, THE SHORTHAND FOR WHICH IS THE

"C TO S PROBLEM." SECOND, WHETHER CURRENT LAW'S ONE CLASS OF STOCK LIMIT IS APPROPRIATE; SUBSUMED WITHIN THE ONE CLASS OF STOCK ISSUE IS A SERIES OF CONCERNS THAT MARCH UNDER THE "DEBT:EQUITY" BANNER. THIRD, WHETHER LIMITS ON FOREIGN INCOME ARE APPROPRIATE.

OF THESE THREE ISSUES, BY A WIDE MARGIN THE MOST SIGNIFICANT IN MY VIEW IS THE C TO S PROBLEM: THEREFORE THE BULK OF THIS SUBMISSION WILL BE DEVOTED TO THAT PROBLEM. I BELIEVE IT IS THE PARAMOUNT ISSUE BECAUSE A CONCEPTUALLY SOUND AND SIMPLIFYING RESOLUTION OF IT IS KEY TO SENSIBLY RESOLVING A NUMBER OF THE IMPORTANT AND VERY TROUBLESOME QUESTIONS TO WHICH MR. ROSTENKOWSKI'S STATEMENT ALSO MADE REFERENCE. THESE INCLUDE THE PASSIVE GROSS RECEIPTS LIMITATION ON S CORPORATION QUALIFICATION AND THE PROPER TREATMENT OF IN-KIND DISTRIBUTIONS OF APPRECIATED PROPERTY BY AN S CORPORATION.

I. THE APPROACH OF THE BILL

PRESENT SUBCHAPTER S IS A CORPORATE-SHAREHOLDER INTEGRATION CONSTRUCT. ESSENTIALLY, THE S CORPORATION COMPUTES ITS TAXABLE INCOME AS IF IT WERE A C CORPORATION BUT ENJOYS A DIVIDENDS PAID DEDUCTION. UNDISTRIBUTED NET INCOME AT YEAR END IS DEEMED PAID TO THE THEN SHAREHOLDERS. ALTHOUGH OTHER CORPORATE INCOME IS NOT SCHEDULED, LONG-TERM CAPITAL GAIN RETAINS THAT CHARACTER IN FAVOR OF THE SHAREHOLDERS BUT CAPITAL GAIN TAX IS LEVIED AT BOTH CORPORATE AND SHAREHOLDER LEVELS, IN THE CIRCUMSTANCES DESCRIBED IN PRESENT SECTION 1378, IF THE ENTITY HAS SHIFTED FROM C TO S STATUS WITHIN THE PRECEDING THREE YEARS. THE SIGNAL DEPARTURE FROM THE

INTEGRATION MODE, HOWEVER, RELATES TO NET OPERATING LOSSES; THESE PASS THROUGH TO THE SHAREHOLDERS ON A DAILY BASIS.

BECAUSE PRESENT SUBCHAPTER S IS AN INTEGRATION CONSTRUCT, EXCEPT AS SPECIFICALLY VARIED OR NEGATED THE OFTEN ARCANE RULES OF SUBCHAPTER C RETAIN VITALITY. MOST IMPORTANT, WHEN A C CORPORATION SHIFTS TO S STATUS ITS ACCUMULATED EARNINGS AND PROFITS CARRY FORWARD. EXCESS DISTRIBUTIONS BY THE S CORPORATION ARE OUT OF ACCUMULATED EARNINGS AND PROFITS AND SUBJECT THE SHAREHOLDERS TO DIVIDEND TREATMENT. IN OPERATION, THE CURRENT RULES IMPOSE A DRASTIC PENALTY ON DISTRIBUTIONS OF APPRECIATED PROPERTY.

IN GENERAL, THE BILL WOULD MOVE FROM THE PRESENT INTEGRATION CONSTRUCT TO A PASSTHROUGH REGIME ANALOGOUS TO THE SUBCHAPTER K TAX TREATMENT OF PARTNERS AND PARTNERSHIPS. WHENEVER THE MATTER IS MATERIAL, EACH ITEM OF INCOME, DEDUCTION, EXCLUSION, AND THE LIKE WILL RETAIN ITS CHARACTER IN THE HANDS OF THE SHAREHOLDER. AGAIN WITH A NOD TO SUBCHAPTER K, DAILY RATHER THAN YEAR-END SHAREHOLDER INCOME COMPUTATION IS REQUIRED, THE SHAREHOLDER'S BASIS IS INCREASED TO REFLECT ATTRIBUTED EARNINGS, AND THE SHAREHOLDER'S BASIS IS DECREASED TO REFLECT DISTRIBUTIONS OUT OF THOSE EARNINGS. THESE ARE MERITORIOUS CHANGES IN THE TAXING SCHEME.

WITH RESPECT TO LONG-TERM CAPITAL GAIN, THE BILL RETAINS THE SECTION 1378 DOUBLE TAX RULE. THIS SEEMS TO ME COMPREHENSIBLE IN LIGHT OF THE BILL'S OVERALL APPROACH TO THE C TO S ISSUE. BUT THE SECTION 1378 DOUBLE TAX OVERWHELMS THE PROBLEM TO WHICH IT IS ADDRESSED. UNDER A BETTER DESIGNED APPROACH TO THE C TO S ISSUE, SECTION 1378 CAN BE REVISED TO AFFECT ONLY THE NARROW CLASS OF CASES THAT MERIT THE BURDEN OF ITS ATTENTION.

THE BILL DEPARTS FROM THE PURE PASSTHROUGH APPROACH OF SUBCHAPTER K IN A NUMBER OF OTHER WAYS. IT CONTEMPLATES NOTHING EQUIVALENT TO SECTIONS 734(B), 735, 736, 743(B), 751, 752, 753, AND 754. IN ITS RETICENCE THE BILL STRIKES A MAJOR BLOW FOR TAX SIMPLIFICATION. THE CITED PROVISIONS OF SUBCHAPTER K ARE AMONG THE MOST COMPLEX AND TROUBLESOME SECTIONS OF THE INTERNAL REVENUE CODE. WITH A VIEW TO ENHANCING FLEXIBILITY AND EQUITY, IN SOME CASES FOR THE BENEFIT OF TAXPAYERS AND IN OTHERS FOR THE PROTECTION OF THE FISC, THESE SUBCHAPTER K PROVISIONS HAVE MADE LARGE SEGMENTS OF PARTNERSHIP TAXATION THE DOMAIN OF THE MOST SOPHISTICATED PRACTITIONERS, A SWAMP BEST AVOIDED BY THE MERELY COMPETENT. IF SUBCHAPTER S IS BEAMED MAINLY TOWARD SMALL BUSINESS, IN REJECTING THESE COMPLEX RULES THE BILL MOVES IN THE RIGHT DIRECTION.

IN THE SAME LINE OF APPROACH TOWARD BALANCING EQUITY AND SIMPLICITY, THE BILL TREATS APPRECIATED PROPERTY DISTRIBUTIONS BY AN S CORPORATION IN A LESS SATISFACTORY WAY. WHEN A PARTNERSHIP DISTRIBUTES APPRECIATED PROPERTY TO A PARTNER, NO GAIN IS RECOGNIZED AND THE PARTNER SUCCEEDS TO THE PROPERTY AT A BASIS EQUAL TO THE LOWER OF ITS BASIS IN THE HANDS OF THE PARTNERSHIP OR THE PARTNER'S BASIS IN HIS INTEREST IN THE PARTNERSHIP. IN GENERAL, IF THE DISTRIBUTED PROPERTY CARRIES AN ORDINARY INCOME COMPONENT, DEPRECIATION RECAPTURE PROPERTY OR UNREALIZED RECEIVABLES OR SUBSTANTIALLY APPRECIATED INVENTORY, THE PARTNER WHO SUBSEQUENTLY

COLLECTS UPON OR DISPOSES OF THE ASSET IS TARRED WITH THE ORDINARY INCOME BRUSH. THERE ARE, HOWEVER, EXCEPTIONS FOR CERTAIN ASSETS HELD BY THE PARTNER AN EXTENDED TIME AND ALL MANNER OF DIFFICULTIES THAT RELATE TO NON PRO RATA PARTNERSHIP DISTRIBUTIONS, TRACING OBLIGATIONS, AND THE LIKE. THE BILL SENSIBLY AVOIDS THESE COMPLICATIONS BY TREATING AS A TAXABLE SALE THE DISTRIBUTION OF ORDINARY INCOME ASSETS BY AN S CORPORATION TO ITS SHAREHOLDERS. BUT, FOR A QUITE DIFFERENT AND LESS ATTRACTIVE REASON THAT DEVOLVES FROM THE C TO S PROBLEM, THE BILL EXTENDS FORCED RECOGNITION TO DISTRIBUTIONS OF CAPITAL GAIN PROPERTIES. A MORE SENSIBLE RESOLUTION, ONE THAT CAN BE ACHIEVED ONLY THROUGH A BETTER APPROACH TO THE C TO S PROBLEM, WOULD POSTPONE RECOGNITION WHEN LONG-TERM CAPITAL GAIN PROPERTY IS DISTRIBUTED TO THE S CORPORATION'S SHAREHOLDERS.

II. A CONCEPTUAL APPROACH TO THE C TO S ISSUE

THE DOMINANT ALTHOUGH NOT THE EXCLUSIVE COMPONENT OF THE C TO S PROBLEM IS ACCUMULATED EARNINGS AND PROFITS. THE BILL CLEARLY REACTS TO THIS REALITY IN PROPOSING THAT THE PASSIVE GROSS RECEIPTS LIMITATION ON S CORPORATION QUALIFICATION, PRESENT SECTION 1372-(E)(5), NO LONGER WILL APPLY TO A CORPORATION THAT HAS NO C HISTORY OR TO A FORMER C CORPORATION THAT HAS ELIMINATED ITS ACCUMULATED EARNINGS AND PROFITS BY YEAR-END. THESE ARE IMPORTANT AND WELCOME CHANGES. THEY DO NOT GO FAR ENOUGH.

ACCUMULATED EARNINGS AND PROFITS IS THE GENESIS OF THE BILL'S PROPOSAL TO TREAT AS A TAXABLE SALE THE DISTRIBUTION OF LONG-TERM

CAPITAL GAIN PROPERTY BY AN S CORPORATION. THAT RECOGNITION RULE IS INTENDED TO PROVIDE A TAXPAYER ADVANTAGE, NOT A PENALTY. SALE TREATMENT PRODUCES SHAREHOLDER CAPITAL GAIN IN THE S CORPORATION WORLD, ABSENT AN APPLICATION OF SECTION 1239, WHERE A SIMPLE DISTRIBUTION OF THE PROPERTY OUT OF ACCUMULATED EARNINGS AND PROFITS WOULD PRODUCE ORDINARY DIVIDEND INCOME TO THE SHAREHOLDERS. ADDITIONALLY, UNDER STANDARD DISTRIBUTION RULES THE CORPORATION'S ACCUMULATED EARNINGS AND PROFITS WOULD BE REDUCED, NOT BY THE VALUE OF THE PROPERTY DISTRIBUTED, BUT ONLY BY THE BASIS OF THAT PROPERTY, CREATING THE POTENTIAL OF REPLICATING DIVIDEND TRANSMUTATIONS ON FUTURE IN-KIND DISTRIBUTIONS BY THE S CORPORATION. BUT, WHILE IMMEDIATE CAPITAL GAIN WITHOUT DOUBT IS MORE ACCEPTABLE THAN REITERATED DIVIDEND INCOME WHEN A CAPITAL ASSET MOVES FROM AN S CORPORATION TO ITS SHAREHOLDERS, THAT RESPONSE IS HARDLY CONSISTENT WITH THE PASSTHROUGH NATURE OF NEW SUBCHAPTER S AND NO TAX SIMPLIFICATION DIRECTIVE MANDATES SALE TREATMENT. TO ACHIEVE AN APPROPRIATE RESOLUTION, HOWEVER, REQUIRES REEXAMINATION OF THE ACCUMULATED EARNINGS AND PROFITS RULE.

IN A BASIC WAY, AN S ELECTION BY A C CORPORATION IS A FORM OF LIQUIDATION. SETTING ASIDE THE SPECIAL SECTION 1378 DOUBLE TAX RULE, THE S ELECTION LIFTS THE BURDEN OF THE CORPORATE TAX FROM THE FUTURE INCOME STREAM THAT THE BUSINESS AND ASSETS OF THE ENTERPRISE WILL GENERATE. WHEN THE SHAREHOLDERS ARE INDIVIDUALS, THE COMPLETE LIQUIDATION OF A CORPORATION PRODUCES THE SAME TAX RESULT. IN BOTH CASES, FUTURE INCOME WILL BE SINGLE TAXED AT INDIVIDUAL TAX RATES.

THIS IS HARDLY A NEW PERCEPTION. FROM TIME-TO-TIME OVER THE PAST QUARTER CENTURY THE EQUATION HAS PARENTED THE OBVIOUS ARGUMENT THAT AN S ELECTION BY A C CORPORATION SHOULD BE TAXED AS A COMPLETE LIQUIDATION. THE ARGUMENT HAS NOT PERSUADED, PERHAPS LARGELY BECAUSE THERE IS LITTLE APPETITE IN OR OUT OF CONGRESS TO IMPOSE THE HEAVY COMBINED BURDEN OF CORPORATE LEVEL TAX RECAPTURES AND SHAREHOLDER GAIN RECOGNITION AS THE PRICE OF SHIFTING TO A SINGLE TAX REGIME.

THE REFUSAL TO IMPOSE A COMPLETE LIQUIDATION TAX BURDEN CAN BE JUSTIFIED ON A DIFFERENT AND LESS INTENSELY PRAGMATIC GROUND. THE COMPLETE LIQUIDATION OF A CORPORATION UNDER SECTION 331 DOES MORE THAN LIFT THE BURDEN OF THE CORPORATE TAX FROM THE FUTURE INCOME STREAM. ASSET BASIS IS STEPPED-UP TO FAIR MARKET VALUE. WHILE THE FUTURE STREAM OF GROSS RECEIPTS IS NOT AFFECTED, THE ADDITIONAL BASIS AWARDED ASSETS HELD FOR SALE, DEPRECIATION, AMORTIZATION, AND DEPLETION SUBSTANTIALLY REDUCES THE STREAM OF FUTURE TAXABLE INCOME. THERE IS THUS ANOTHER EQUATION TO BE DERIVED, ONE I THINK MORE INFORMATIVE IN RESOLVING THE C TO S PROBLEM.

WHEN CORPORATE ASSETS ARE SIGNIFICANTLY APPRECIATED AND THE ENTERPRISE COMPLETELY LIQUIDATES, UNDER CURRENT TAX RULES AND RATES THE PRESENT VALUE OF FUTURE TAX BENEFITS, ELIMINATED GAIN ON ORDINARY INCOME ASSET SALES AND AUGMENTED DEPRECIATION AND THE LIKE, REASONABLY APPROXIMATES THE IMMEDIATE TAX LIABILITY ATTRACTED BY THAT LIQUIDATION. IN SOME CASES THE IMMEDIATE COST IS

HIGHER, IN OTHERS IT IS LESS THAN THE PRESENT VALUE OF THE FUTURE TAX BENEFITS, BUT IN THE AGGREGATE THE APPROXIMATION IS SUFFICIENT.

IF THERE IS AN ADEQUATE BALANCE BETWEEN THE BURDEN OF IMMEDIATE TAX AND THE BENEFIT OF FUTURE TAX REDUCTION, IT OUGHT LOGICALLY BE ACCEPTABLE BOTH TO TAXPAYERS AND TO THE TREASURY, UNDER THE LIQUIDATION ANALOGY, THAT IMMEDIATE TAX RELATIVE TO CORPORATE ASSET APPRECIATION NOT BE COLLECTED PROVIDED THE CORPORATION'S BASIS IN ITS APPRECIATED ASSETS, AND THUS FULL LIABILITY FOR INDIVIDUAL TAX ON THE FUTURE INCOME STREAM, IS PRESERVED. THE ACCEPTANCE OF THAT NOTION IS ESSENTIAL TO A CONCEPTUALLY AND PRACTICALLY SATISFACTORY RESOLUTION OF THE C TO S ISSUE. SPECIFICALLY, IT DIRECTS OUR ATTENTION TO THE FOLLOWING CONSIDERATIONS.

FIRST, THE KEY TO AN EFFECTIVE RATIONALIZATION AND SIMPLIFICATION OF SUBCHAPTER S IS ELIMINATION OF ACCUMULATED EARNINGS AND PROFITS. IF EVERY S CORPORATION WERE NEW BORN, WE WOULD HAVE NO REASON TO IMPOSE A PASSIVE GROSS RECEIPTS LIMITATION OR ANY OTHER QUALIFICATION LIMITATION, WE WOULD HAVE NO REASON TO TAX DISTRIBUTIONS OF CAPITAL GAIN PROPERTY, AND WE WOULD HAVE NO REASON TO BE CONCERNED THAT THE ENTITY RECEIVES AND DISTRIBUTES TAX EXEMPT INTEREST. WE WOULD ADOPT SIMPLE AND WORKABLE TAX RULES APPROPRIATE TO A SMALL BUSINESS TAXING REGIME. SIMILARLY, IF EVERY CORPORATION SHIFTING FROM C TO S STATUS WERE PURGED OF ITS ACCUMULATED EARNINGS AND PROFITS ACCOUNT, WE COULD AND WOULD APPLY THE SAME SIMPLE AND WORKABLE S RULES. OUR FOCUS, THEREFORE, SHOULD BE ON HOW BEST TO PURGE THE ACCOUNT.

SECOND, WE CAN SENSIBLY APPROACH THAT QUESTION THROUGH THE LIQUIDATION ANALOGY, TAKING AS OUR MODEL A CONSTRUCTED SET OF RULES UNDER WHICH ASSET BASIS IS PRESERVED AND THE APPRECIATION IN THE VALUE OF THE CORPORATION'S ASSETS ATTRACTS NO IMMEDIATE TAX LIABILITY AT EITHER THE CORPORATION OR THE SHAREHOLDER LEVEL. REMAINING FOR CONSIDERATION UNDER THE LIQUIDATION ANALOGY IS THE CORPORATION'S ACCUMULATED EARNINGS AND PROFITS. NOW, HOWEVER, THE FOCUS IS ON THE RELATIONSHIP OF ACCUMULATED EARNINGS AND PROFITS TO THE BASIS AT WHICH THE CORPORATION HOLDS ITS ASSETS.

THE AGGREGATE BASIS OF A CORPORATION'S ASSETS IS THE SUM OF NET SHAREHOLDER INVESTMENT, THE CORPORATION'S LIABILITIES, AND ITS ACCUMULATED EARNINGS AND PROFITS.*/ IN COMMON TAX PARLANCE, NET ASSET BASIS IS AGGREGATE BASIS MINUS CORPORATE LIABILITIES. THE INFORMATIVE AGGREGATE COMPARISON IS BETWEEN THE CORPORATION'S NET ASSET BASIS AND THE SHAREHOLDERS' BASIS IN THEIR SHARES; THE INFORMATIVE INDIVIDUAL COMPARISON IS BETWEEN THE SHAREHOLDER'S BASIS IN HIS SHARES AND HIS PROPORTIONATE PART OF THE CORPORATION'S NET ASSET BASIS. IGNORING FOR THE MOMENT CHANGES IN SHAREHOLDERS AND SHAREHOLDINGS, AS TO EACH INVESTOR THAT DIFFERENCE APPROXIMATES HIS RATABLE SHARE OF THE CORPORATION'S ACCUMULATED EARNINGS AND PROFITS.

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*/ IN FACT, UNDER §312(K) AND THE LIKE, BASIS AND ACCUMULATED EARNINGS AND PROFITS (AEP) WILL DIVERGE. BUT, BECAUSE THE DIFFERENCE REMAINS LOCKED IN THE CORPORATION AS FUTURE INCOME, THE CORRECT COMPARISON IS BETWEEN ASSET BASIS AND AEP DETERMINED WITHOUT REGARD TO §312(K)-TYPE ADJUSTMENTS.

THE BASIS FORMULATION IS USEFUL BECAUSE IT DEALS WITH READILY ASCERTAINABLE FIGURES -- A CORPORATION CAN BE EXPECTED TO KNOW THE ADJUSTED BASIS OF ITS ASSETS -- AND BECAUSE BASIS DIFFERENTIALS BEST MEASURE THE UNCOMPENSATED ADVANTAGE OF A SHIFT FROM C TO S STATUS. THAT IS, WHILE THE ADVANTAGE OF AVOIDING IMMEDIATE TAX ON CORPORATE ASSET APPRECIATION IS COMPENSATED BY THE PRESERVATION OF HISTORIC ASSET BASIS, NOTHING IN PRESENT LAW OFFSETS THE ADVANTAGE THAT ACCRUES TO THE SHAREHOLDER WHEN HIS PROPORTIONATE PART OF THE CORPORATION'S NET ASSET BASIS IS HIGHER THAN HIS BASIS IN THE SHARES.

A WORD ON CHANGES IN SHAREHOLDERS AND SHAREHOLDINGS. IF MR. A RECENTLY PURCHASED FROM A PRIOR SHAREHOLDER AT FAIR VALUE, HIS SHARE BASIS IS FAR HIGHER THAN THE AMOUNT ORIGINALLY INVESTED. BUT THE INTERNAL-EXTERNAL BASIS COMPARISON NONETHELESS HOLDS SINCE THE EXTERNAL BASIS INCREASE PRODUCED BY THE PURCHASE OF SHARES MEASURES THE PRIOR HOLDER'S SALE GAIN. THE LIQUIDATION ANALOGY REMAINS VALID IF WE VIEW AS A UNIT MR. A AND HIS PREDECESSOR. WHILE THE CASE IS DIFFERENT IF MR. A INHERITED RATHER THAN PURCHASED THE SHARES, THE CONGRESSIONAL POLICY EMBEDDED IN SECTION 1014(A) REQUIRES THAT WE IMPOSE NO ADDITIONAL TAX IN RESPONSE TO THAT DIFFERENCE.

THIS BRINGS ME TO THE THIRD POINT. FROM THE LIQUIDATION ANALOGY AND THE INTERNAL-EXTERNAL BASIS COMPARISON IT FOLLOWS, WHEN A CORPORATION SHIFTS FROM C TO S STATUS, THAT ACCUMULATED EARNINGS AND PROFITS CAN BE EXPUNGED BY RECOGNIZING TO EACH SHAREHOLDER CAPITAL GAIN IN THE AMOUNT BY WHICH HIS PROPORTIONATE

PART OF THE CORPORATION'S NET ASSET BASIS EXCEEDS THE SHAREHOLDER'S BASIS IN HIS SHARES. BASIS DIFFERENTIAL IS THE APPROPRIATE AMOUNT BECAUSE IT FAIRLY APPROXIMATES ATTRIBUTABLE EARNINGS AND PROFITS. CAPITAL GAIN RATHER THAN ORDINARY INCOME IS APPROPRIATE BECAUSE LIQUIDATION IS THE PROPER ANALOGY.

FINALLY, THERE ARE MATTERS OF AMELIORATION. A ONCE PROFITABLE C CORPORATION MAY HAVE SUFFERED SUBSTANTIAL REDUCTION IN THE VALUE OF ITS ASSETS. WHEN THE BASIS OF THE CORPORATION'S ASSETS EXCEEDS VALUE, MEASURING SHAREHOLDER CAPITAL GAIN BY THE DIFFERENCE BETWEEN INTERNAL AND EXTERNAL BASIS IMPOSES AN INAPPROPRIATELY HEAVY BURDEN. A C CORPORATION SHIFTING TO S STATUS, OR AN S CORPORATION THAT SHIFTED FROM C STATUS YEARS AGO, MAY HAVE SUBSTANTIAL ACCUMULATED EARNINGS AND PROFITS BUT NOT THE LIQUIDITY THAT WOULD PERMIT IT TO FUND SUBSTANTIAL AND IMMEDIATE SHAREHOLDER CAPITAL GAIN TAX. BECAUSE THE RATIONALITY OF THE TAXING SYSTEM WILL BE SIGNIFICANTLY ENHANCED THROUGH ELIMINATION OF THE ACCUMULATED EARNINGS AND PROFITS ACCOUNT, THE TOLL CHARGE SYSTEM SHOULD BE MADE AS ATTRACTIVE AS COMPETING POLICIES ALLOW. SPREADING THE TAX BURDEN OVER TIME MEETS THAT OBJECTIVE. AND, BECAUSE THERE WILL BE CASES IN WHICH INTRACTABLE PROBLEMS OF LIQUIDITY OR OTHER CONSIDERATIONS MILITATE AGAINST THE PAYMENT OF ANY TOLL CHARGE, WRITING ON A SLATE THAT IS NOT CLEAN CONGRESS OUGHT TO PROVIDE AN ALTERNATIVE TRACK WITHIN SUBCHAPTER S TO ACCOMMODATE CORPORATIONS THAT WILL NOT PURGE ACCUMULATED EARNINGS AND PROFITS.

III. A TWO TRACK C TO S PROPOSAL

THE PROPOSAL HERE ADVANCED IS FOR A TWO TRACK SUBCHAPTER S WORLD. IN TRACK I, NEWLY ORGANIZED S CORPORATIONS (HAVING BY DEFINITION NO C HISTORY AND THUS NO ACCUMULATED EARNINGS AND PROFITS), FORMER C CORPORATIONS WHICH THROUGH ORDINARY DISTRIBUTION HAVE FULLY PURGED ACCUMULATED EARNINGS AND PROFITS, FORMER C CORPORATIONS THAT ELECT TO PURGE ACCUMULATED EARNINGS AND PROFITS THROUGH THE SHAREHOLDER TOLL CHARGE MECHANISM DESCRIBED HEREAFTER, AND S CORPORATIONS WHICH IN A CORPORATE REORGANIZATION INHERIT THE ACCUMULATED EARNINGS AND PROFITS OF AN ABSORBED C CORPORATION AND ELECT TO PURGE THE ACCOUNT USING THE TOLL CHARGE MECHANISM. IN SUM, ANY NEWLY CREATED S CORPORATION AND ANY FORMER C CORPORATION THAT DOES NOT HAVE ACCUMULATED EARNINGS AND PROFITS IS WITHIN TRACK I. TRACK II COVERS THE BALANCE: S CORPORATIONS WITH ACCUMULATED EARNINGS AND PROFITS ATTRIBUTABLE TO A C CORPORATION HISTORY.

A. COMMON RULES

TO THE MAXIMUM EXTENT FEASIBLE, THE SAME RULES OUGHT TO APPLY WHETHER THE S CORPORATION IS ON TRACK I OR TRACK II. THUS, AS THE BILL NOW PROVIDES, PROVISIONS RELATING TO SHAREHOLDER CONSENTS, MID-YEAR TERMINATION OF S STATUS, AND RELATED PARTY TRANSACTIONS AND REALLOCATIONS OUGHT TO APPLY UNIFORMLY. SIMILARLY, WHILE IDENTICAL DISTRIBUTION RULES CANNOT GOVERN THE TWO TRACKS, THE BILL'S PROPOSED ITEM PASSTHROUGH REGIME, REPLACING THE CORPORATE-SHAREHOLDER INTEGRATION APPROACH OF PRESENT LAW, SHOULD APPLY TO ALL S CORPORATIONS.

B. Choice of Track

Automatically, every S corporation newly organized after the effective date of the Act will commence its S Corporation existence on track I. Every pre-Act S corporation that has no earnings and profits attributable to a C history will be on track I.

In all other cases, a choice between the tracks must be made and, in formulating the legislation, the first task is to identify a norm, the track on which the S corporation will run if no election is made. Sensitive to the potential of blunder the norm should be track II, the regime that will not subject shareholders to unexpected toll charge. In that vein, the following structure is recommended.

-- If, after the effective date of the Act, a C corporation shifts to S status, it is on track II unless it affirmatively elects (as part of the S election) and all of the shareholders consent to track I. If that election is made, the toll charge applies to all who are shareholders on the first day of the first S year.

-- If, at the commencement of the first taxable year following the effective date of the Act, an S corporation with accumulated earnings and profits attributable to a C past wishes to choose track I, it may so elect before the close of the first two and a half months of the taxable year. All who are shareholders on election day, and all who were shareholders on the first day of the taxable year, must consent. The toll charge will attach to those who were shareholders on the first day.

Suppose the S corporation does not elect track I for the first post-effective date taxable year but wishes to make the election in a subsequent year? There are arguments for and against the granting of that permission and I will turn to them later.

-- If, after the effective date of the Act, a track I S corporation acquires in an asset reorganization the properties and attributes, including the accumulated earnings and profits, of either a C corporation or a track II S corporation, the acquiring corporation immediately will be remitted to track II unless a toll charge election is made. That election should be available within two and a half months of the reorganization and should require the consent of all persons who were shareholders of the acquired company and, in the reorganization, become shareholders of the acquiring corporation. The toll charge should attach only to those shareholders.

C. Track I Toll Charge

As of the first day of the electing S corporation's taxable year, there shall be determined for each affected shareholder the amount, if any, by which his percentage of the corporation's net asset basis exceeds his aggregate basis in the shares of the S corporation. This amount is the shareholder's basis differential. There also shall be determined the amount, if any, by which the fair market value of the shares exceeds the shareholder's aggregate basis in those shares. This is the shareholder's gain limitation amount. The toll charge relates to the

LOWER OF THE BASIS DIFFERENTIAL OR THE GAIN LIMITATION AMOUNT. I WILL REFER TO THIS LOWER AMOUNT AS THE SHAREHOLDER'S TOLL CHARGE BASE.

SUBJECT TO ACCELERATION AS DESCRIBED BELOW, THE SHAREHOLDER WILL INCLUDE IN HIS INCOME, AS CAPITAL GAIN, 20% OF THE TOLL CHARGE BASE ON THE FIRST DAY OF THE S CORPORATION'S FIRST TRACK I YEAR, AND 20% OF THE TOLL CHARGE BASE ON THE FIRST DAY OF EACH OF THE NEXT FOUR SUCCEEDING SUBCHAPTER S YEARS. ON EACH OCCASION, THE SHAREHOLDER'S BASIS IN HIS SHARES WILL BE INCREASED BY AN AMOUNT EQUAL TO THE INCLUDED SUM. THE CAPITAL GAIN IS LONG-TERM CAPITAL GAIN PROVIDED THE SHAREHOLDER ENJOYED A LONG-TERM HOLDING PERIOD ON THE DATE OF INCLUSION. THE CAPITAL GAIN RESULT OBTAINS WHETHER OR NOT THE CORPORATION IS "COLLAPSIBLE" WITHIN THE MEANING OF SECTION 341(B).

BECAUSE TOLL CHARGE IS IMPOSED ONLY ON THE FIRST DAY OF AN S YEAR, IF THE CORPORATION LIQUIDATES OR TERMINATES ITS S ELECTION TOLL CHARGE WILL NOT THEREAFTER BE IMPOSED. IF, HOWEVER, THE CORPORATION RETAINS ITS S STATUS BUT, ACQUIRING THE ACCUMULATED EARNINGS AND PROFITS OF ANOTHER CORPORATION IN A REORGANIZATION, CHOOSES NOT TO MAKE THE APPROPRIATE ELECTION AND THUS IS REMITTED TO TRACK II, THE TOLL CHARGE WILL REMAIN IN EFFECT. THIS IS A TAXPAYER PROTECTIVE RULE SINCE A DIFFERENT APPROACH WOULD REQUIRE RESORT TO THE ANTI-BAILOUT RULES SET OUT BELOW.

IF WITHIN THE FIVE YEAR INCLUSION TERM THE SHAREHOLDER DISPOSES OF PART OR ALL OF HIS SHARES, IN ANY MANNER OTHER THAN BY REASON OF DEATH, THE APPROPRIATE PART OF THE DEFERRED TOLL CHARGE

IS ACCELERATED AND THE SHAREHOLDER'S BASIS IN THE TRANSFERRED SHARES CONCOMITANTLY INCREASED. THUS, A SALE OR GIFT OF 1/2 THE SHARES WILL REQUIRE INCLUSION OF 1/2 THE DEFERRED CAPITAL GAIN AND INCREASE BY THAT AMOUNT THE BASIS OF THE SHARES TRANSFERRED (EFFECTIVE IMMEDIATELY PRIOR TO THE TRANSFER). DISPOSITION BY REASON OF DEATH SHOULD NOT ACCELERATE TOLL CHARGE. INSTEAD, THE ESTATE OR OTHER SUCCESSOR TO THE SHARES SHOULD INHERIT THE TOLL CHARGE ACCOUNT, TREATED IN THE NATURE OF A SECTION 691 ITEM, AND BECAUSE SHARE BASIS ALREADY HAS BEEN STEPPED-UP UNDER SECTION 1014(A) SUBSEQUENT TOLL CHARGE INCLUSION WILL NOT FURTHER INCREASE SHARE BASIS. THESE RESULTS ARE CONSISTENT WITH THE LIQUIDATION ANALOGY THAT UNDERLIES THE TOLL CHARGE CONCEPT.

THERE IS AN ADDITIONAL CIRCUMSTANCE IN WHICH ACCELERATION OF TOLL CHARGE SHOULD BE REQUIRED. THE FIVE YEAR SPREAD FORWARD IS PREMISED ON A LIQUIDITY CONCERN, AND IT IS IN AID OF SIMPLIFICATION THAT THE PROPOSAL DOES NOT REQUIRE A DEMONSTRATION THAT THE CONCERN IS WELL PLACED IN A GIVEN CASE. BUT IF THE S CORPORATION DEMONSTRATES THE CONTRARY, THROUGH EXCESS DISTRIBUTION, CONTINUED DEFERRAL OF TOLL CHARGE IS INAPPROPRIATE. ACCORDINGLY, IF DURING THE FIRST YEAR OF THE DEFERRAL TERM THE S CORPORATION DISTRIBUTES TO THE SHAREHOLDER AN AMOUNT IN EXCESS OF HIS PERCENTAGE OF THE CORPORATION'S NET INCOME FOR THAT YEAR PLUS HIS TOLL CHARGE BASE AMOUNT FOR THAT YEAR, THAT EXCESS SHOULD BE INCLUDABLE (AS AT THE LAST DAY OF THE S CORPORATION'S YEAR) AS AN ACCELERATION OF TOLL CHARGE BASE IN DIRECT ORDER OF MATURITY. ON AN AGGREGATING BASIS, THE SAME RULES SHOULD APPLY IN SUBSEQUENT YEARS.

D. ELIMINATION OF ACCUMULATED EARNINGS AND PROFITS

UNDER THE LIQUIDATION ANALOGY AND COMPARATIVE BASIS ANALYSIS SET OUT ABOVE,THE TRACK I TOLL CHARGE ABSORBS ACCUMULATED EARNINGS AND PROFITS. ACCORDINGLY, UPON THE MAKING OF A TRACK I ELECTION AND EFFECTIVE AT THE COMMENCEMENT OF THAT TAXABLE YEAR THE S CORPORATION IS DEEMED TO HAVE ELIMINATED IN FULL ITS ACCUMULATED EARNINGS AND PROFITS. SO LONG AS THE S CORPORATION RETAINS ITS TRACK I STATUS, NO DISTRIBUTION, REDEMPTION, OR OTHER TRANSACTION CAN GIVE RISE TO A TAXABLE DIVIDEND.

E. EARNINGS AND PROFITS OF A "PURE" S CORPORATION

A "PURE" S CORPORATION, ONE THAT HAS NO SUBCHAPTER C HISTORY, AUTOMATICALLY IS ON TRACK I. UNDER PRESENT LAW, A PURE S CORPORATION MAY HAVE ACCUMULATED EARNINGS AND PROFITS. PROPERLY, THE BILL PROVIDES THAT IN THE NEW WORLD EARNINGS AND PROFITS CANNOT BE CREATED OR INCREASED WHILE THE ENTITY IS AN S CORPORATION. TO HARMONIZE OLD LAW AND NEW IN AN UNCOMPLICATED WAY, IT SHOULD BE PROVIDED THAT ANY ACCUMULATED EARNINGS AND PROFITS OF A PURE S CORPORATION ARE EXPUNGED UPON ENACTMENT OF THE BILL, WITHOUT THE IMPOSITION OF ANY TOLL CHARGE ON THE SHAREHOLDERS.

F. ELIMINATION OF PASSIVE GROSS RECEIPTS LIMITATION

APPROPRIATELY, THE BILL PROVIDES THAT NO PASSIVE GROSS RECEIPTS LIMITATION OR OTHER QUALIFICATION LIMITATION WILL APPLY TO A PURE S CORPORATION OR TO AN S CORPORATION THAT HAS ELIMINATED ALL EARNINGS AND PROFITS BY YEAR-END. THIS SALUTARY RULE SHOULD BE EXTENDED TO ALL TRACK I CORPORATIONS SINCE, BY DEFINITION, ALL OF THEM HAVE ELIMINATED ACCUMULATED EARNINGS AND PROFITS.

G. TRACK I ELIMINATION OF PRESENT SECTION 1378

PRESENT SECTION 1378 IMPOSES AN ADDITIONAL LONG-TERM CAPITAL GAIN TAX, IN THE NATURE OF A CORPORATE LEVEL EXCISE, IF WITHIN THREE YEARS FOLLOWING SHIFT FROM C TO S STATUS THE CORPORATION RECOGNIZES "EXCESS" LONG-TERM CAPITAL GAIN. THE BILL PROPOSES TO PRESERVE THIS RULE. CURRENTLY, SECTION 1378 FUNCTIONS, RATHER INADEQUATELY, AS A BAILOUT PREVENTION DEVICE. OTHER THAN AS PART OF A BETTER FORMULATED SET OF ANTI-BAILOUT RULES, SECTION 1378 HAS NO SENSIBLE PLACE IN A TRACK I TAXING REGIME. IT IS THEREFORE PROPOSED THAT, FOR TRACK I CORPORATIONS, PRESENT SECTION 1378 BE REPEALED. THE BAILOUT CONCERN TO WHICH THE PROVISION APPARENTLY RELATES IS ADDRESSED SEPARATELY.

H. TRACK I DISTRIBUTION RULES

SETTING ASIDE TOLL CHARGE ACCELERATION, A CASH DISTRIBUTION BY A TRACK I S CORPORATION REDUCES STOCK BASIS, AND PRODUCES NO TAXABLE GAIN TO THE RECIPIENT UNLESS AND UNTIL BASIS IS EXHAUSTED. THIS FOLLOWS THE SUBCHAPTER K RULE.

DISTRIBUTION OF APPRECIATED LONG-TERM CAPITAL GAIN PROPERTY WILL NOT BE TREATED AS A TAXABLE DISPOSITION BY THE CORPORATION. AGAIN FOLLOWING THE SUBCHAPTER K RULE, THE SHAREHOLDER RECEIVES THE PROPERTY AT A BASIS EQUAL TO THE LOWER OF THE CORPORATION'S BASIS OR THE SHAREHOLDER'S AGGREGATE STOCK BASIS, AND THAT STOCK BASIS IS EQUIVALENTLY REDUCED.

AS AN EXCEPTION TO THE GENERAL RULE OF NONRECOGNITION WHEN CAPITAL GAIN PROPERTY IS DISTRIBUTED, IF THE ASSET IS EN-

CUMBERED IN EXCESS OF BASIS THE DIFFERENCE WILL BE RECOGNIZED, AND IF THE PROPERTY IS DISTRIBUTED IN A STOCK REDEMPTION SECTION 311(D) WILL BE IN POINT.

THE DISTRIBUTION OF APPRECIATED PROPERTY OTHER THAN LONG-TERM CAPITAL GAIN PROPERTY WILL BE TREATED, AS IT IS TREATED UNDER THE BILL, AS A TAXABLE DISPOSITION BY THE S CORPORATION. THE RESULTING RECAPTURE OR OTHER ORDINARY INCOME OR SHORT-TERM GAIN WILL FLOW THROUGH TO THE SHAREHOLDERS IN THE STANDARD WAY, INCREASING CONCOMITANTLY STOCK BASIS. IN THE HANDS OF THE SHAREHOLDER, THE DISTRIBUTED PROPERTY WILL HAVE A BASIS EQUAL TO THE CORPORATION'S BASIS INCREASED BY THE GAIN RECOGNIZED, BUT NOT MORE THAN THE SHAREHOLDER'S AGGREGATE STOCK BASIS (AFTER INCREASE TO REFLECT THE RECOGNIZED GAIN). ORDINARILY, UNDER THIS FORMULA THE BASIS OF THE DISTRIBUTED PROPERTY IN THE HANDS OF THE SHAREHOLDER WILL EQUAL FAIR MARKET VALUE.

DISTRIBUTION OF PROPERTY WORTH LESS THAN BASIS WILL TRIGGER NO ALLOWABLE LOSS. IN THE SHAREHOLDER'S HANDS, BASIS WILL CARRY OVER FROM THE CORPORATION (BUT NOT IN EXCESS OF THE SHAREHOLDER'S AGGREGATE STOCK BASIS) AND THE CHARACTER OF THE PROPERTY, ORDINARY OR CAPITAL, WILL BE THE CHARACTER APPROPRIATE TO THE SHAREHOLDER'S HOLDING AND USE OF THE PROPERTY. IF, HOWEVER, THE DISTRIBUTION OF DEPRECIATED PROPERTY IS IN REDEMPTION OF STOCK, BASIS IN THE SHAREHOLDER'S HANDS SHOULD BE DETERMINED IN ACCORDANCE WITH THE DIRECTIVES OF SECTIONS 302 AND 301.

FINALLY, IN DETERMINING WHETHER AND IN WHAT AMOUNT A DISTRIBUTION MAY ACCELERATE TOLL CHARGE, SIMPLIFICATION IS ENHANCED IF DISTRIBUTED PROPERTY IS TAKEN AT AN AMOUNT EQUAL TO ITS BASIS IN THE HANDS OF THE RECIPIENT SHAREHOLDER. UNDER THIS APPROACH VALUATION OF THE PROPERTY, NOT OTHERWISE REQUIRED UNDER THE DISTRIBUTION RULES WHEN, FOR EXAMPLE, THE DISTRIBUTED ASSET IS LONG-TERM CAPITAL GAIN PROPERTY, IS NOT REQUIRED UNDER THE TOLL CHARGE RULES.

I. TRACK I BAILOUT PREVENTION RULES

AT THE COST OF A CAPITAL GAIN TOLL CHARGE TO THE SHAREHOLDERS, UNDER THE PROPOSED REGIME A C CORPORATION MAY ELECT TRACK I SUBCHAPTER S STATUS AND IMMEDIATELY DISTRIBUTE CASH OR CAPITAL GAIN PROPERTY EQUAL TO THE FULL AMOUNT OF ITS NOW EXPUNGED ACCUMULATED EARNINGS AND PROFITS. THIS FAVORABLE TREATMENT IS SUPPORTABLE UNDER THE LIQUIDATION ANALOGY. BUT IF THE CORPORATION, HAVING DISTRIBUTED, TOO QUICKLY REVERTS TO C STATUS, AWARDING CAPITAL GAIN TREATMENT TO THE DISTRIBUTION CLEARLY IS UNACCEPTABLE. IT IS UNACCEPTABLE CONCEPTUALLY BECAUSE THE LIQUIDATION ANALOGY HAS BROKEN DOWN. TAKEN AS A WHOLE, THE ARRANGEMENT HAS PROVED THE FUNCTIONAL EQUIVALENT OF A LIQUIDATION-REINCORPORATION TRANSACTION. REPAIRING TO THAT MODEL, DIVIDEND TAX IS THE APPROPRIATE RESPONSE.

THE PROBLEM OF AN UNTIMELY DOUBLE SHIFT -- FROM C TO TRACK I S AND BACK TO C -- PRESENTS THE POTENTIAL OF THREE DIFFERENT SORTS

OF INAPPROPRIATE BAILOUT. THE FIRST AND MOST IMPORTANT IS THE DISGUISED DIVIDEND, WHAT I WILL REFER TO AS THE AEP (ACCUMULATED EARNINGS AND PROFITS) BAILOUT. THE SECOND, DERIVATIVE OF THE PROPOSED REPEAL OF SECTION 1378 WITH RESPECT TO TRACK I CORPORATIONS, IS A SALE BAILOUT. THE THIRD, DERIVATIVE OF THE PROPOSAL THAT DISTRIBUTIONS OF APPRECIATED CAPITAL GAIN PROPERTY OCCASION NO TAX AND ATTRACT CARRYOVER BASIS, IS A DISTRIBUTION BAILOUT. I WILL DISCUSS EACH IN TURN.

AT THE THRESHOLD, IN ORDER TO CRAFT REASONABLE BUT NOT OVERWHELMING RULES TO INHIBIT INAPPROPRIATE BAILOUT, IT IS NECESSARY TO IDENTIFY WHAT CONSTITUTES A "TOO QUICK" REVERSION TO C CORPORATION STATUS. I WOULD PROPOSE THAT FOR AEP BAILOUT THE APPROPRIATE PERIOD IS FIVE YEARS COMMENCING THE FIRST DAY OF THE FIRST TRACK I YEAR, A PERIOD ESSENTIALLY EQUIVALENT TO THE FIVE YEAR DEFERRAL TERM AWARDED UNDER THE TOLL CHARGE RULES, AND THAT FOR SALE AND DISTRIBUTION BAILOUT THE APPROPRIATE PERIOD IS FIVE YEARS COMMENCING THE FIRST DAY OF THE FIRST S YEAR (WHETHER ON TRACK I OR TRACK II OR UNDER PRE-ACT LAW).

THE FOLLOWING OUTLINES THE SUGGESTED BAILOUT PREVENTION RULES. IN EACH CASE IT IS ASSUMED THAT WITHIN THE FIVE YEAR PROTECTION TERM THE TRACK I CORPORATION RETURNS TO C STATUS, EITHER EXPLICITLY ELECTING TO TERMINATE, UNDERGOING A DISQUALIFYING EVENT, OR REORGANIZING WITH AND INTO A C CORPORATION.

1. AEP BAILOUT

AT THE TIME THE CORPORATION REVERTS TO C STATUS, EACH INDIVIDUAL WHO WAS A SHAREHOLDER ON THE FIRST DAY OF THE FIRST

TRACK I S YEAR (OR WHO THEREAFTER RECEIVED SHARES, DERIVED FROM AN ORIGINAL SHAREHOLDER, BY GIFT OR IN A RELATED PARTY SALE) AND WHO IS NOT SANITIZED UNDER ANY OF THE EXEMPTIONS SUMMARIZED BELOW, IS TREATED AS HAVING RECEIVED A DIVIDEND. THE DIVIDEND IS EQUAL TO THE LESSER OF (1) THE AMOUNT OF MONEY AND THE INITIAL BASIS (IN HIS HANDS) OF OTHER PROPERTY THAT WAS DISTRIBUTED TO HIM BY THE S CORPORATION, IN EXCESS OF HIS SHARE OF THE S CORPORATION'S NET INCOME THAT WAS TAXABLE TO HIM, OR (2) HIS RATABLE SHARE OF THE CORPORATION'S ACCUMULATED EARNINGS AND PROFITS DETERMINED IMMEDIATELY PRIOR TO THE CORPORATION'S SHIFT FROM C TO S STATUS.

NO GAIN, INCOME, OR LOSS IS RECOGNIZED TO THE CORPORATION UNDER THE AEP BAILOUT RULE. HOWEVER, IN ITS NEW C INCARNATION THE CORPORATION IS DEEMED TO HAVE ACCUMULATED EARNINGS AND PROFITS EQUAL TO THE DIFFERENCE BETWEEN ITS ACCUMULATED EARNINGS AND PROFITS AS AT THE CLOSE OF ITS PRIOR C EXISTENCE AND THE AGGREGATE AMOUNT TREATED AS DIVIDEND INCOME TO SHAREHOLDERS UNDER THE AEP BAILOUT RULE.

EXEMPT FROM THE IMPUTED DIVIDEND IS ANY SHAREHOLDER WHO DIED PRIOR TO REVERSION TO C STATUS, ANY PERSON WHO RECEIVED THE SHARES FROM THE DECEDENT, AND ANY SHAREHOLDER WHO TRANSFERRED HIS SHARES TO A PERSON WHO IS NOT A RELATED PERSON (SECTION 318 OTHER THAN PARAGRAPH (A)(4) THEREOF) PRIOR TO THE TIME THE CORPORATION REVERTS TO C STATUS. THUS, A SHAREHOLDER WHO HAS SOLD ALL OF HIS SHARES TO AN UNRELATED PURCHASER IS NOT AT RISK. A SHAREHOLDER WHO HAS SOLD HALF OF HIS SHARES TO AN UNRELATED PURCHASER HAS

ELIMINATED THE POTENTIAL OF IMPUTED DIVIDEND WITH RESPECT TO THAT HALF.

BEYOND THE AUTOMATIC EXEMPTIONS, THE STATUTE SHOULD CONTAIN A PROVISION UNDER WHICH IMPUTED DIVIDEND WILL BE AVOIDED IF THE SHAREHOLDER CAN DEMONSTRATE TO THE SATISFACTION OF THE COMMISSIONER AN ABSENCE OF TAX AVOIDANCE MOTIVE. THIS OR A PARALLEL PROVISION SHOULD AUTHORIZE THE PROMULGATION OF REGULATIONS TO ESTABLISH A PROCEDURE UNDER WHICH A SHAREHOLDER, TAXED ON IMPUTED DIVIDEND INCOME, MAY, IN PROPER CIRCUMSTANCES AND WITH APPROPRIATE ADJUSTMENT TO SHARE BASIS, CREDIT OR OTHERWISE OFFSET TOLL CHARGE CAPITAL GAIN TAX.

WITH AN EYE TO LIMITING THE COMPLEXITY OF RULES THAT ARE NOT IN ANY EVENT THE SIMPLEST, NO ADJUSTMENT SHOULD BE MADE IN THE BASIS AT WHICH THE SHAREHOLDER HOLDS PROPERTY THAT WAS DISTRIBUTED WHILE THE CORPORATION WAS IN S STATUS. THIS CONCLUSION IS CONSISTENT WITH THE DETERMINATION TO MEASURE PROPERTY DISTRIBUTIONS, UNDER THE AEP BAILOUT RULE, AT AN AMOUNT EQUAL TO BASIS IN THE HANDS OF THE RECIPIENT SHAREHOLDER.

2. SALE BAILOUT

IN FOCUS IS LONG-TERM CAPITAL GAIN RECOGNIZED BY THE S CORPORATION, AND PASSED THROUGH TO THE SHAREHOLDERS, WHILE THE CORPORATION WAS "TEMPORARILY" ON TRACK I.

AT THE TIME THE CORPORATION TOO QUICKLY REVERTS TO C STATUS, IT SHOULD BE TAXED (AT THE C CORPORATION LONG-TERM CAPITAL GAIN RATE) ON AN AMOUNT EQUAL TO THE AGGREGATE NET CAPITAL

GAIN THAT WAS RECOGNIZED (BUT PASSED THROUGH TO THE SHAREHOLDERS) DURING THE TRACK I TERM. THE CORPORATION IS THE TAXPAYER WITH RESPECT TO THIS SPECIAL TAX. IN ESSENCE, THE TAX IS A TAILORED REPLACEMENT FOR THE REPEALED SECTION 1378.

NO ADJUSTMENT IS MADE AT THE SHAREHOLDER LEVEL, AND IT IS THUS IRRELEVANT WHETHER THERE HAS BEEN A CHANGE IN SHAREHOLDERS DURING THE PERIOD THE CORPORATION WAS ON TRACK I.

3. DISTRIBUTION BAILOUT

DURING ITS SOJOURN ON TRACK I THE CORPORATION MAY DISTRIBUTE TO ITS SHAREHOLDERS APPRECIATED LONG-TERM CAPITAL GAIN PROPERTY. UNDER THE TRACK I DISTRIBUTION RULES, NO GAIN IS RECOGNIZED AND THE SHAREHOLDERS TAKE OVER THE PROPERTY AT A BASIS EQUAL, NORMALLY, TO BASIS IN THE HANDS OF THE DISTRIBUTING CORPORATION.

UNDER THE AEP BAILOUT RULE, IMPUTED DIVIDEND IS MEASURED BY THE BASIS OF THE DISTRIBUTED PROPERTY, NOT ITS GREATER FAIR MARKET VALUE. THUS, THE AEP BAILOUT RULE, STANDING ALONE, DOES NOT ELIMINATE THE POTENTIAL OF SIGNIFICANT TAX AVOIDANCE SINCE RESALE BY THE SHAREHOLDERS PRODUCES CAPITAL GAIN.

THE SOLUTION, FORTUNATELY UNCOMPLICATED, FOLLOWS THE APPROACH TO SALE BAILOUT. AT THE TIME THE CORPORATION REVERTS TO C STATUS, IT SHOULD BE TREATED AS RECOGNIZING LONG-TERM CAPITAL GAIN EQUAL TO THE VALUE OF THE DISTRIBUTED PROPERTY, IN EXCESS OF THE CORPORATION'S BASIS, MEASURED AS AT THE TIME OF DISTRIBUTION. THE CORPORATION IS THE TAXPAYER WITH RESPECT TO THIS SPECIAL CAPITAL GAIN TAX. NO ADJUSTMENT IS MADE AT THE SHAREHOLDER LEVEL, EITHER IN THE BASIS AT WHICH THE DISTRIBUTED PROPERTY IS HELD OR OTHERWISE. ALTHOUGH THIS APPROACH TO THE DISTRIBUTION PROBLEM DOES REQUIRE VALUATION OF THE PROPERTY, ONLY ONE TAXPAYER, THE CORPORATION ITSELF, WILL BE INVOLVED IN THE POTENTIAL VALUATION DISPUTE.

4. C TO S WITHOUT ACCUMULATED EARNINGS AND PROFITS

ASSUME A C CORPORATION HOLDS SUBSTANTIALLY APPRECIATED CAPITAL ASSETS AND IS BURDENED WITH ONLY MODEST ACCUMULATED EARNINGS AND PROFITS. IN 1983 THE C CORPORATION DISTRIBUTES ORDINARY CASH DIVIDENDS EQUAL TO THE TOTAL ACCUMULATION. IN 1984 IT ELECTS S STATUS AND, HAVING NO ACCUMULATED EARNINGS AND PROFITS, IS AUTOMATICALLY ON TRACK I. THE CORPORATION PROMPTLY SELLS THE CAPITAL ASSETS PRODUCING SUBSTANTIAL LONG-TERM CAPITAL GAIN TO ITS SHAREHOLDERS AND DISTRIBUTES THE CASH. IN 1985 THE CORPORATION REVERTS TO C STATUS.

THE SHAREHOLDERS IN THE EXAMPLE CASE ARE NOT SUBJECT TO TOLL CHARGE AND ARE EXEMPT FROM THE AEP BAILOUT RULE SINCE, AT THE TIME OF ITS 1984 ELECTION, THE CORPORATION HAD NO ACCUMULATED EARNINGS AND PROFITS. NONETHELESS, THE SALE BAILOUT RULE SHOULD APPLY TO THE CASE DESCRIBED, AND THE DISTRIBUTION BAILOUT RULE SHOULD APPLY IF THE APPRECIATED CAPITAL ASSETS ARE DISTRIBUTED TO THE SHAREHOLDERS RATHER THAN SOLD BY THE CORPORATION. STATING THE POINT THE OTHER WAY ROUND, IT IS IMPORTANT THAT THE LEGISLATION MAKE IT CLEAR THAT THE SALE BAILOUT AND DISTRIBUTION BAILOUT RULES ARE APPLICABLE TO ANY TRACK I CORPORATION, HAVING A C CORPORATION

HISTORY, IF THE ENTITY REVERTS TO C CORPORATION STATUS WITHIN FIVE YEARS AFTER IT BECAME AN S CORPORATION. UNDER THIS FORMULATION, AN S CORPORATION WITH NO C HISTORY IS EXEMPT, AND A C CORPORATION THAT SHIFTED TO OLD LAW S STATUS ON JANUARY 1, 1978 AND (WITH ACCUMULATED EARNINGS AND PROFITS) ELECTS TRACK I STATUS ON JANUARY 1, 1983, IS EXEMPT FROM THE SALE AND DISTRIBUTION BAILOUT RULES BUT IS NOT EXEMPT FROM THE AEP BAILOUT RULE.

5. A FEW SPECIAL ISSUES

IF DURING THE RELEVANT FIVE YEAR PROTECTION TERM THE TRACK I CORPORATION ADOPTS A PLAN OF LIQUIDATION UNDER SECTION 333, THE ADOPTION OF THAT PLAN SHOULD BE TREATED AS A REVERSION TO C STATUS FOR PURPOSES OF THE AEP BAILOUT RULE. IN ADDITION, IF THE PLAN IS IMPLEMENTED DURING THE FIRST FIVE S YEARS, THE DISTRIBUTION BAILOUT RULE SHOULD APPLY TO ANY STOCK OR SECURITIES, DISTRIBUTED DURING THE TRACK I TERM, WHICH WERE HELD BY THE CORPORATION LONG-TERM AND WORTH IN EXCESS OF BASIS AT THE TIME OF DISTRIBUTION.

IF DURING THE RELEVANT FIVE YEAR PROTECTION TERM THE CORPORATION ADOPTS A PLAN OF LIQUIDATION UNDER SECTION 331, IT SHOULD BE TREATED AS HAVING REVERTED TO SUBCHAPTER C STATUS SOLELY FOR PURPOSES OF THE DISTRIBUTION BAILOUT RULE AND SOLELY WITH RESPECT TO LONG-TERM CAPITAL GAIN PROPERTY THAT WAS DISTRIBUTED TO SHAREHOLDERS, DURING THE TRACK I SOJOURN, PRIOR TO THE DATE THE SECTION 331 PLAN OF LIQUIDATION IS ADOPTED.

AN S CORPORATION WILL SHIFT FROM TRACK I TO TRACK II IF IT ACQUIRES ACCUMULATED EARNINGS AND PROFITS INCIDENT TO AN ACQUI-

SITIVE CORPORATE REORGANIZATION AND A TRACK I ELECTION, RELATIVE TO THE ABSORBED ENTITY AND ITS SHAREHOLDERS, IS NOT MADE. PROVIDED THE CORPORATION CONTINUES AS AN S CORPORATION, EVEN THOUGH ON TRACK II, THE SHIFT SHOULD NOT TRIGGER APPLICATION OF ANY OF THE THREE BAILOUT RULES. IF, HOWEVER, THE CORPORATION SUBSEQUENTLY REVERTS TO C STATUS WITHIN FIVE YEARS OF ITS ORIGINAL S ELECTION, THE SALE AND DISTRIBUTION BAILOUT RULES THEN WILL COME INTO PLAY.

J. ACCUMULATED EARNINGS TAX

IN THE NEW WORLD AS UNDER CURRENT LAW, AN S CORPORATION IS NOT SUBJECT TO THE ACCUMULATED EARNINGS TAX. PRESENT LAW AFFORDS AN ADDITIONAL MEASURE OF RELIEF: A DISTRIBUTION DURING THE FIRST TWO AND A HALF MONTHS OF THE FIRST S YEAR RELATES BACK TO THE LAST C YEAR AND, IN PRACTICAL EFFECT, RENDERS SECTION 531 INAPPLICABLE TO THAT FINAL C YEAR.

UNDER THE BILL IT WOULD NOT APPEAR THAT THE S YEAR DISTRIBUTION WILL PRODUCE A DIVIDENDS PAID DEDUCTION IN COMPUTING ACCUMULATED EARNINGS TAX LIABILITY IN THE FINAL C YEAR. THIS CHANGE, PRESUMABLY UNINTENDED, IS NOT NECESSARILY TO BE DEPLORED. IN ANY EVENT, THE CONCERN IS ABSORBED WITHIN A LARGER ONE.

UNDERPINNING THE PROPOSAL ADVANCED IN THIS PAPER IS A STRONG BELIEF THAT THE TAX SYSTEM WILL WORK IN A MORE SENSIBLE AND LESS COMPLEX WAY IF CLOSELY HELD CORPORATIONS ARE ENCOURAGED TO ENTER AND REMAIN ON TRACK I. THE TOLL CHARGE THAT THIS ENTAILS IS MANAGEABLE IF THE CORPORATION IS FREE TO DISTRIBUTE CASH WITH WHICH THE TAX PAYMENTS CAN BE MADE, AND IS FAR MORE THAN MANAGEABLE IF

THE CORPORATION IS FREE TO DISTRIBUTE TO ITS SHAREHOLDERS SUBSTANTIALLY MORE THAN THEIR TOLL CHARGE TAX LIABILITY.

IF A PROFITABLE C CORPORATION ELECTS S STATUS ON TRACK I AND MAKES DISTRIBUTIONS OUT OF PREVIOUSLY ACCUMULATED EARNINGS, AN AUDITING REVENUE AGENT MAY WELL BE ENCOURAGED TO ASSERT SECTION 531 TAX FOR OPEN SUBCHAPTER C YEARS. THE CORPORATION, IT CAN BE CLAIMED, HAS DEMONSTRATED THAT THE PRIOR ACCUMULATIONS WERE NOT REQUIRED TO MEET THE NEEDS OF THE CONTINUING BUSINESS. FACED WITH THIS RISK, MANY CORPORATIONS WILL BE INHIBITED FROM ELECTING TRACK I.

I DO NOT THINK THIS AN ISSUE LIGHTLY TO BE SHRUGGED ASIDE. TRACK I WILL NOT BE POPULAR IF THE ELECTION OF IT ATTRACTS, OR IS FEARED TO ATTRACT, A DOUBLE TOLL CHARGE, THE STATUTORY CAPITAL GAIN IMPOST AND RETROACTIVELY IMPOSED ACCUMULATED EARNINGS TAX. IT SEEMS TO ME IMPORTANT, AND PERHAPS ESSENTIAL, THAT THE SPECIAL SECTION 531 CONCERN BE AMELIORATED.

IN LIGHT OF THE CURRENT DIVIDENDS PAID DEDUCTION RULES, A PARTIAL RESPONSE MIGHT BE TO PROVIDE BY STATUTE THAT SECTION 531 WILL NOT APPLY TO THE FINAL C YEAR OF A CORPORATION THAT ELECTS SUBCHAPTER S TRACK I. ALTERNATIVELY OR CUMULATIVELY, BY STATUTE OR REGULATION (SUPPORTED BY COMMITTEE REPORT) IT COULD BE DECLARED THAT A TRACK I ELECTION AND SUBSEQUENT DISTRIBUTIONS SHALL BE DISREGARDED IN DETERMINING WHETHER THE CORPORATION, PRIOR TO THE ELECTION YEAR, ACCUMULATED EARNINGS AND PROFITS BEYOND THE REASONABLE NEEDS OF ITS BUSINESS.

K. Some Track I Issues to Be Resolved

There are of course many other matters to be resolved in constructing Track I. Although most of them will emerge as further work is done on the proposal, some are now apparent.

1. Delayed Elections

As outlined above, each candidate is awarded one free Track I election: A C corporation when it first elects S status; a pre-Act S corporation (with accumulated earnings and profits) in its first post-Act taxable year; and a Track I S corporation at the time it acquires a C corporation (with accumulated earnings and profits) in a reorganization.

Assume the C corporation shifting to S status, or the pre-Act S corporation with accumulated earnings and profits, does not make the Track I election when it is first available. As a Track II S corporation, may it elect Track I in a later year, and may it do so freely or will consent of the Commissioner be required?

Arguing for later free election is the policy in favor of expanding Track I. Even a capital gain toll charge spread over five years may appear an excessive burden at one stage of the corporation's life, but eminently affordable at a later time. A contrary argument recognizes the shareholders may be entirely able to pay the toll charge but are content to defer until an event, perhaps the corporation's purchase of a large quantity of municipal bonds, renders Track I specially desirable.

In addition to free choice and Commissioner's consent, another possibility is to allow a later election without the

COMMISSIONER'S CONSENT BUT TO REQUIRE THAT THE FULL TOLL CHARGE BASE BE RECOGNIZED TO THE SHAREHOLDER AT THE TIME THE SHIFT TO TRACK I IS MADE. THE CHOICE AMONG THESE AND ANY OTHER APPROACHES IS A JUDGMENT CALL.

THE CORPORATE REORGANIZATION CASE IS DIFFERENT. THOSE WHO SHOULD INCUR THE TOLL CHARGE ARE THE FORMER SHAREHOLDERS OF THE C CORPORATION WHO CONTINUE AS SHAREHOLDERS IN THE COMBINED CORPORATION. IF THE TRACK I ELECTION IS NOT IMMEDIATE, A SUBSEQUENT ELECTION PRESENTS OBVIOUS PROBLEMS. HERE THE CONSENT OF THE COMMISSIONER, ON SUCH TERMS AS HE MAY IMPOSE, SEEMS THE BETTER COURSE.

2. POSSIBLE APPLICATION OF DEBT BASIS

AS FORMULATED ABOVE, THE TRACK I DISTRIBUTION RULES LOOK ONLY TO THE SHAREHOLDER'S STOCK BASIS IN DETERMINING WHEN AND IN WHAT AMOUNT A CASH DISTRIBUTION WILL BE TAXED, AND IN LIMITING THE BASIS OF DISTRIBUTED PROPERTY IN THE HANDS OF THE SHAREHOLDER. THE RULES COULD BE REFORMULATED TO LOOK TO THE AGGREGATE BASIS OF THE SHAREHOLDER'S STOCK AND DEBT HOLDINGS IN THE S CORPORATION.

3. CERTAIN NON PRO RATA DISTRIBUTIONS

AS FORMULATED ABOVE, THE TRACK I DISTRIBUTION RULES PROVIDE NONRECOGNITION AND CARRYOVER BASIS TREATMENT WHEN LONG-TERM CAPITAL GAIN PROPERTY IS DISTRIBUTED IN CIRCUMSTANCES TO WHICH SECTION 311(C) AND SECTION 311(D)(1) DO NOT APPLY. IT IS AT LEAST ARGUABLE THAT THIS TREATMENT SHOULD BE LIMITED TO PRO RATA DISTRI-

BUTIONS, AND THAT A DISPROPORTIONATE DISTRIBUTION OUGHT TO REQUIRE RECOGNITION OF GAIN PASSING THROUGH TO ALL OF THE SHAREHOLDERS. I BELIEVE THIS IS A MATTER THAT DESERVES FURTHER STUDY.

IV. TRACK II

BY DEFINITION A TRACK II ENTITY IS AN S CORPORATION THAT RETAINS ACCUMULATED EARNINGS AND PROFITS FROM A SUBCHAPTER C HISTORY.

A. QUALIFICATION LIMITATION

PRESENT SECTION 1372(E)(5), WITH ACCUMULATED EARNINGS AND PROFITS IN MIND, IMPOSES A 20% PASSIVE GROSS RECEIPTS LIMITATION REQUIREMENT ON SUBCHAPTER S QUALIFICATION. IT IS COMMONLY ASSERTED, ALTHOUGH PERHAPS NOT ENTIRELY CLEAR, THAT SOUND POLICY REQUIRES THAT THIS OR SOME EQUIVALENT QUALIFICATION LIMITATION APPLY TO WHAT NOW WILL BE TRACK II CORPORATIONS. THERE ARE AT LEAST THREE MAIN POSSIBILITIES AND A NUMBER OF SUBSIDIARY VARIATIONS.

1. PASSIVE GROSS RECEIPTS TEST

ONE POSSIBILITY IS TO MAINTAIN A PASSIVE GROSS RECEIPTS LIMITATION. SOME CHANGES IN THE CURRENT VERSION ARE, I BELIEVE, ESSENTIAL; OTHERS MERIT SERIOUS CONSIDERATION.

-- AN ANTI-CHURNING RULE IS NEEDED. UNDER THE CURRENT LIMITATION AN S CORPORATION QUICKLY CAN GENERATE VERY SUBSTANTIAL "ACTIVE" GROSS RECEIPTS BY PURCHASING AND SELLING, ON A HIGHLY LEVERAGED BASIS, QUANTITIES OF GOLD, SILVER, OR OTHER COMMODITIES. IF THE LIMITATION IS TO BE EFFECTIVE, ONLY COMMODITY GAINS, NOT GROSS RECEIPTS, SHOULD BE TAKEN INTO ACCOUNT.

-- When ordinary income property is sold on the installment method, interest received or accrued on the installment obligations should be treated as "active" gross receipts. This is an important and needed change.

-- Consideration should be given to treating as "active" gross receipts the interest received or accrued on any installment obligation, provided principal payments on the obligation qualify as active gross receipts.

-- Consideration should be given to classifying as "active" the income received from the rental of property, at least in those cases in which the adjusted income from rents (as defined in section 543(b)(2)(A)) is a major component of the corporation's receipts.

-- The 20% figure should be re-examined to determine whether a higher percentage would adequately protect the interests of the fisc. Re-examination is appropriate since an increase in the percentage should reduce the risk of inadvertent termination of S status.

2. Personal Holding Company Income Test

Another approach would replace the passive gross receipts limitation with a personal holding company income test. The S status of a Track II corporation would terminate if, in any year, more than a specified percentage of the corporation's adjusted ordinary gross income is personal holding company income.

THE DEFINITION OF THE LATTER TERM, CONTAINED IN SECTION 543(A), WOULD REQUIRE SOME REVISION.

-- IN DETERMINING PERSONAL HOLDING COMPANY INCOME FOR S QUALIFICATION PURPOSES, SECTION 543(A)(2) SHOULD BE APPLIED WITHOUT REGARD TO SUBPARAGRAPH (B) THEREOF. THAT SUBPARAGRAPH KEYS TO DIVIDEND DISTRIBUTIONS, AN IRRELEVANT CONCEPT IN THE NEW SUBCHAPTER S WORLD.

-- INTEREST ON INSTALLMENT OBLIGATIONS, GENERATED IN A SALE OF ORDINARY INCOME PROPERTY, SHOULD BE EXCLUDED FROM PERSONAL HOLDING COMPANY INCOME.

3. A COMBINED APPROACH

A PASSIVE GROSS RECEIPTS LIMITATION HAS BEEN CRITICIZED BECAUSE IT DISQUALIFIES A VARIETY OF CORPORATIONS THAT ARE IN FACT CONDUCTING ACTIVE BUSINESSES. A PERSONAL HOLDING COMPANY INCOME TEST IS CONCEIVED TO AVOID THIS DEFECT, BUT INAPPROPRIATELY MAY DISQUALIFY CORPORATIONS THAT WOULD NOT BE AT RISK UNDER A GROSS RECEIPTS LIMITATION. THE FAMILIAR EXAMPLE IS A CORPORATION, SUFFERING BUSINESS REVERSAL, WHICH HAS SUBSTANTIAL GROSS RECEIPTS FROM SALES, NO ACTIVE ORDINARY GROSS INCOME DUE TO THE COST OF THOSE SALES, AND A SMALL AMOUNT OF BANK INTEREST INCOME. WHILE THE EXAMPLE POSITS A RATHER EXTRAORDINARY CASE, IT IS NOT AN INCONCEIVABLE ONE.

A THIRD APPROACH WOULD COMBINE THE TESTS. S STATUS ON TRACK II WOULD NOT BE TERMINATED UNLESS THE CORPORATION VIOLATES

BOTH A PASSIVE GROSS RECEIPTS LIMITATION AND A PERSONAL HOLDING COMPANY INCOME TEST. UNDER THE COMBINED APPROACH, THE PRESENT PASSIVE GROSS RECEIPTS LIMITATION SHOULD BE ALTERED ONLY IN THE TWO NECESSARY RESPECTS, ANTI-CHURNING AND INTEREST ON CUSTOMER-GENERATED INSTALLMENT OBLIGATIONS, AND NO CHANGE SHOULD BE MADE IN THE 20% FIGURE OR WITH REGARD TO RENTAL INCOME OR INTEREST ON NON-CUSTOMER INSTALLMENT OBLIGATIONS. WITH NEITHER ENDORSEMENT NOR DISAPPROVAL, I PUT FORTH THE COMBINED APPROACH FOR STUDY.

B. TRACK II DISTRIBUTION RULES

AS UNDER THE BILL, DISTRIBUTION OF ANY SORT OF APPRECIATED PROPERTY BY A TRACK II CORPORATION SHOULD BE TREATED AS A TAXABLE SALE OF THAT PROPERTY. IF THE PROPERTY IS DEPRECIABLE AND THE SHAREHOLDER IS DEEMED TO OWN AT LEAST 80% OF THE CORPORATION'S STOCK, SECTION 1239 WILL BE APPLICABLE. IF THE DISTRIBUTED PROPERTY IS WORTH LESS THAN ITS BASIS IN THE HANDS OF THE CORPORATION, NO LOSS WILL BE RECOGNIZED AND, IN THE HANDS OF THE SHAREHOLDER, BASIS WILL EQUAL FAIR MARKET VALUE.

THE BILL'S APPROACH TO EXCESS DISTRIBUTIONS THAT INVADE ACCUMULATED EARNINGS AND PROFITS IS SOUND AND SHOULD BE FOLLOWED.

C. PRESENT SECTION 1378

PRESENT SECTION 1378 SHOULD BE RETAINED FOR TRACK II CORPORATIONS, BUT A MODIFICATION IS IN ORDER.

UNDER THE CURRENT RULE, THE CORPORATE LEVEL TAX IS IMPOSED ON LONG-TERM CAPITAL GAIN RECOGNIZED DURING THE FIRST THREE

S YEARS. SECTION 1378 HAS NO APPLICATION IF CAPITAL GAIN PROPERTY IS SOLD ON THE INSTALLMENT METHOD DURING ANY OF THESE YEARS BUT PAYMENT IS NOT RECEIVED UNTIL THE FOURTH S YEAR. EITHER OF TWO CHANGES SHOULD BE MADE.

THE PROVISION COULD BE AMENDED TO IMPOSE THE CORPORATE LEVEL TAX ON CAPITAL GAIN RECOGNIZED IN ANY S YEAR IF THE SALE OCCURS PRIOR TO THE CLOSE OF THE THIRD S YEAR. ALTERNATIVELY, AND I BELIEVE PREFERABLY, THE STATUTE COULD BE CHANGED TO IMPOSE THE CORPORATE LEVEL TAX ON LONG-TERM CAPITAL GAIN RECOGNIZED IN ANY OF THE FIRST FIVE S YEARS. I THINK THIS THE PREFERABLE ROUTE BECAUSE IT COMPORTS WITH THE FIVE YEAR APPROACH TAKEN THROUGHOUT THE PROPOSED TRACK I RULES.

V. ONE CLASS OF STOCK LIMIT

LIMITING THE S CORPORATION TO A SINGLE CLASS OF STOCK (UNDER THE BILL, SENSIBLY WITHOUT REGARD TO DIFFERENCES IN VOTING POWER) IS DESIGNED TO SIMPLIFY THE OPERATION OF THE SUBCHAPTER. FACIALLY, THE INCOME AND LOSS ALLOCATION PROBLEMS THAT PLAGUE SUBCHAPTER K ARE AVOIDED. BUT IN PRACTICE, OF COURSE, THE MATTER MAY NOT BE SIMPLE. AN INSTRUMENT DENOMINATED DEBT MAY INCORPORATE A PROFIT PARTICIPATION FEATURE, AND LOSS THAT IS ALLOCATED TO THE COMMON STOCK MAY BE THE PRODUCT, NOT OF UNPROFITABLE OPERATION, BUT OF AN EXTRAORDINARY YIELD ACCRUING TO THE NOMINAL INDEBTEDNESS.

WHILE SIMILAR ARRANGEMENTS MAY BE EMPLOYED IN THE C CORPORATION WORLD, THE DEBT:EQUITY CONCERNS THERE ARE NOT IDENTICAL. BECAUSE THE DIFFERENCES ARE IMPORTANT, A THRESHOLD EXPLORATION OF THEM IS INFORMATIVE IN ATTEMPTING TO RESOLVE DEBT:EQUITY ISSUES IN THE S CORPORATION ARENA.

A. SUBCHAPTER C ANALYSIS

A C CORPORATION IS A SEPARATE TAXPAYER. IT IS BASIC TO THAT SYSTEM THAT THE CORPORATION FAIRLY DETERMINE ITS SEPARATE TAX BASE.

IT IS CONVENTIONAL TO STATE THAT OUR SYSTEM OF TAXING C CORPORATIONS AND THEIR SHAREHOLDERS IS NOT INTEGRATED. IN FACT, HOWEVER, THE SYSTEM IS SUBSTANTIALLY INTEGRATED. ONE WHO INVESTS IN A C CORPORATION AS A SHAREHOLDER ALSO IS FREE TO INVEST AS A LENDER. INTEREST PAYMENTS ARE DEDUCTIBLE BY THE CORPORATION AND INCLUDABLE IN THE INVESTOR'S ORDINARY INCOME. IF, BEFORE INTEREST EXPENSE AND TAXES THE CORPORATION EARNS $100,000, BUT INTEREST OF $40,000 IS PAID THE SHAREHOLDER, THE ARRANGEMENT REALISTICALLY MAY BE VIEWED AS ONE UNDER WHICH $60,000 OF NET OPERATING PROFITS ARE TAXABLE TO THE CORPORATION AND $40,000 OF NET OPERATING PROFITS ARE TAXABLE TO THE SHAREHOLDER-LENDER. ON THAT VIEW, THE CORPORATION AND ITS SHAREHOLDER HAVE ESTABLISHED A 40% INTEGRATION ARRANGEMENT.

THE C CORPORATION TAXING REGIME ADMITS THIS SORT OF INTEGRATION BUT IMPOSES LIMITS IN AID OF THE BASIC NOTION THAT THE

C CORPORATION IS A SEPARATE TAXPAYER. IN CONSTRUCTING THEIR ARRANGEMENT, THE PARTIES MUST ALLOT TO THE CORPORATION SOME REASONABLE PART OF THE OPERATING INCOME. HISTORIC CASE LAW ENFORCED THE REQUIREMENT IN RATHER A HEAVY HANDED WAY, VALIDATING THE INTEGRATION ARRANGEMENT IF THE INCOME DIVISION DID NOT TILT TOO STRONGLY IN FAVOR OF THE SHAREHOLDER, AND THROUGH DEBT TO EQUITY RECHARACTERIZATION DENYING ANY INTEGRATION WHEN THE ARRANGEMENT WAS DEEMED TO HAVE GONE TOO FAR. THE REGULATIONS PUBLISHED UNDER SECTION 385 IN PART ATTEMPT TO SUBSTITUTE REASONABLE REALLOCATION FOR THE ALL OR NOTHING APPROACH OF PRIOR CASE LAW.

WHILE THE SECTION 385 REGULATIONS MAKE IMPORTANT USE OF THE REALLOCATION TOOL, BY NO MEANS DO THEY ABANDON THE DEBT DISQUALIFICATION APPROACH. WITH THE OBJECTIVE OF PROTECTING THE C CORPORATION TAX BASE, THE REGULATIONS TREAT AS SUSPECT STRAIGHT DEBT HELD PROPORTIONATELY TO SHAREHOLDINGS, AND DISQUALIFY AS DEBT HYBRID INSTRUMENTS HELD PROPORTIONATELY TO SHAREHOLDINGS. WHILE STRAIGHT DEBT HELD BY NONSHAREHOLDERS IS APPROVED, HYBRID DEBT HELD BY NONSHAREHOLDERS IS DISQUALIFIED IF THE EQUITY FEATURES OF THE INSTRUMENT ARE FOUND TO EXCEED IN VALUE ITS NORMAL DEBT FEATURES. THIS LAST ALSO CAN BE VIEWED AS A REACTION TO EXCESSIVE INTEGRATION, THE HOLDER OF THE HYBRID DEBT BEING SEEN TO FUNCTION AS BOTH A SHAREHOLDER AND A LENDER.

B. COMPARATIVE S CORPORATION ANALYSIS

NONE OF THIS HAS ANY LOGICAL RELEVANCE TO AN S CORPORATION AND ITS SHAREHOLDERS. THERE IS NO SEPARATE S CORPORATION TAX

BASE AND THUS THERE IS NOTHING FOR RULES OF THE DESCRIBED SORT TO PROTECT. THE POINT CAN BE ILLUSTRATED QUITE SIMPLY. IN THE C CORPORATION WORLD DEBT HELD IN EXACT PROPORTION TO SHAREHOLDINGS IS A PRIME FOCUS OF CONCERN. IN THE S CORPORATION WORLD DEBT HELD IN EXACT PROPORTION TO SHAREHOLDINGS IS THE CLEAREST CASE OF NO PROBLEM AT ALL.

WHILE THERE IS NO INTEGRATION ISSUE UNDER SUBCHAPTER S, THERE ARE SIGNIFICANT ISSUES TO WHICH DEBT:EQUITY CLASSIFICATION IS RELEVANT. IT IS IN LIGHT OF THESE ISSUES, NOT MATTERS THAT ARE IRRELEVANT IN A PASSTHROUGH SYSTEM, THAT THE SUBCHAPTER S RULES SHOULD BE DESIGNED.

1. AVOIDING INADVERTENT DISQUALIFICATION

UNDER SUBCHAPTER C, RECHARACTERIZING DEBT AS EQUITY DENIES THE PAYING CORPORATION AN INTEREST DEDUCTION, AND IN A GIVEN CASE MAY OR MAY NOT RESULT IN TAXATION OF THE SHAREHOLDER-CREDITOR ON REPAYMENTS OF PRINCIPAL. IN THE S CORPORATION WORLD, IF RECHARACTERIZED DEBT IS TREATED AS A SECOND CLASS OF STOCK THE ENTITY IS DISQUALIFIED AS AN ELECTING SMALL BUSINESS CORPORATION AND IT AND ALL OF ITS SHAREHOLDERS ARE REMITTED TO THE SUBCHAPTER C REGIME. IN THE RUN OF CASES, THAT IS A PENALTY THAT OVERWHELMS THE CRIME AND IT IS EASY TO UNDERSTAND WHY THE COURTS TO DATE HAVE BEEN EXTREMELY RELUCTANT TO IMPOSE IT.

WE OUGHT TO ATTEND TO THAT WISDOM. WE ARE NOT, AFTER ALL, HERE DEALING WITH THE FORTUNE 500 COMPANIES OR, ORDINARILY, SOPHISTICATED TAX PLANNING OF A WONDERFULLY HIGH RISK AND HIGH REWARD SORT. ONLY IF THERE IS NO OTHER FEASIBLE WAY TO AVOID OR RESOLVE A CLASSIFICATION ISSUE SHOULD WE ENTERTAIN THE FINAL SOLUTION OF TERMINATION.

THAT FIRST PRINCIPLE SUGGESTS THERE MAY BE A WHOLLY UNCOMPLICATED MEANS OF RESOLVING THE INADVERTENT TERMINATION PROBLEM. SUBCHAPTER S COULD BE AMENDED TO AUTHORIZE MULTIPLE CLASSES OF STOCK. I DO NOT RECOMMEND THAT SOLUTION BECAUSE I BELIEVE IT WILL COMPLICATE A TAXING REGIME THAT OUGHT TO BE KEPT AS SIMPLE AS POSSIBLE, AND BECAUSE I DO NOT BELIEVE IT WILL IN FACT FULLY RESOLVE THE INADVERTENT TERMINATION PROBLEM. IF MULTIPLE CLASSES OF STOCK ARE PERMITTED S CORPORATIONS WILL ISSUE THEM, AND WE WILL BE FORCED TO DEAL WITH PROBLEMS OF INCOME AND LOSS ALLOCATION OF PROLIFERATING COMPLEXITY. THE SUBCHAPTER K EXPERIENCE IS BOTH INSTRUCTIVE AND DEPRESSING HERE. AND, BECAUSE WE WILL MAINTAIN IN SUBCHAPTER S AN INELIGIBLE SHAREHOLDER RULE, THE DEBT:EQUITY CLASSIFICATION ISSUE WILL REMAIN POTENT.

2. INELIGIBLE SHAREHOLDERS

A NONRESIDENT ALIEN OR A CHARITY CANNOT HOLD SHARES IN AN S CORPORATION. THIS IS A COMPREHENSIBLE RULE. IT OCCASIONS LITTLE IF ANY COMMERCIAL DISLOCATION AND, WERE THE RULE OTHERWISE, CONGRESS WOULD BE FORCED TO CRAFT PROVISIONS FAR MORE COMPLEX AND INTRUSIVE TO ASSURE THAT TAXABLE INCOME FROM BUSINESS OPERATIONS IS IN FACT TAXED.

A CORPORATION CANNOT HOLD SHARES IN AN S CORPORATION. THE NECESSITY FOR THIS RULE IS LESS CLEAR, AND WILL BE LESS CLEAR STILL UNDER THE PROPOSED ITEM PASSTHROUGH REGIME. PERHAPS THE JUSTIFICATION LIES IN A DESIRE TO PROTECT THE (NOW TO BE 35) SHAREHOLDER LIMIT, THE PRESUMED BASIS FOR DISQUALIFYING AS AN S CORPORATION SHAREHOLDER A PARTNERSHIP OR AN ORDINARY SORT OF TRUST. WHATEVER THE REASONS FOR THESE RESTRICTIONS, IT DOES NOT APPEAR THEY ARE ABOUT TO DEPART THE SCENE AND, IF WE ARE GOING TO HAVE SHAREHOLDER LIMITATIONS, WE OUGHT TO MAKE THEM WORK.

THE FIRST DEBT:EQUITY CONCERN THAT IS SPECIAL TO SUBCHAPTER S, THEN, IS THE HOLDING BY AN INELIGIBLE PERSON OF AN EQUITY FLAVORED INSTRUMENT. BUT IT IS A CONCERN TO BE REFINED, NOT AN AUTOMATIC CONDEMNATION. EQUITY FEATURES DIFFER GREATLY IN THEIR RELEVANCE TO THE SUBCHAPTER S TAXING SYSTEM. IF THE PARAMOUNT OBJECTIVE IS TO AVOID INADVERTENT TERMINATION OF S STATUS TO THE EXTENT FEASIBLE, IT IS NOT THE MERE EXISTENCE OF AN EQUITY FEATURE BUT RATHER THE PARTICULAR NATURE AND QUALITY OF THE EQUITY INTEREST THAT MUST BE CONSULTED.

3. MISALLOCATION OF INCOME OR LOSS

MISALLOCATION OF INCOME OR LOSS IS THE SECOND CLASSIFICATION CONCERN OF HEIGHTENED RELEVANCE UNDER SUBCHAPTER S.

WHEN INVESTORS ARE RELATED, MISALLOCATION MAY BE THE PRODUCT OF INTENDED UNDERCOMPENSATION OF CAPITAL SUPPLIED BY

HIGHER BRACKET FAMILY MEMBERS. BORROWING FROM AND EXPANDING UPON A SUBCHAPTER K PROVISION, THE BILL REACTS APPROPRIATELY IN AUTHORIZING REATTRIBUTION OF INCOME PROPERLY TO REFLECT CAPITAL OR SERVICES FURNISHED. THIS TAILORED REACTION IN THE RELATED PARTY CONTEXT AVOIDS RESORT TO A TERMINATION REMEDY.

SUBCHAPTER K CONTAINS ANOTHER AMELIORATIVE PROVISION NOT FOUND IN THE BILL. SECTION 704(B)(2) AUTHORIZES REATTRIBUTION OF INCOME, GAIN, LOSS, DEDUCTION, OR CREDIT IF, TAKING INTO ACCOUNT ALL FACTS AND CIRCUMSTANCES, THE ARRANGEMENT EMBEDDED IN THE GOVERNING INSTRUMENTS DOES NOT HAVE SUBSTANTIAL ECONOMIC EFFECT. THIS RULES HAS FORCE WHETHER OR NOT THE INVESTORS ARE RELATED.

BECAUSE THE RULE IS AUDIT BASED AND LITIGATION PRODUCTIVE, I DO NOT THINK IT CAN REPLACE THE POSSIBILITY OF TERMINATION IN WHAT IS INTENDED TO BE THE LESS COMPLEX WORLD OF SUBCHAPTER S. BUT I DO BELIEVE A RULE OF THIS SORT HAS A PLACE IN SUBCHAPTER S. FOR EXAMPLE, ASSUME UNRELATED A AND B EACH INVESTS 200 IN A NEW S CORPORATION. A RECEIVES 10 SHARES AND 190 IN STRAIGHT DEBT. B RECEIVES 90 SHARES AND 110 IN STRAIGHT DEBT. BY AGREEMENT, A WHO HAS NO NEED OF CURRENT DEDUCTIONS SUBORDINATES HIS DEBT TO THE DEBT HELD BY B. IF THE S CORPORATION GENERATES A LOSS OF 222, ALMOST 200 OF THAT LOSS WILL FLOW TO B EVEN THOUGH, UNDER THE SUBORDINATION AGREEMENT, ONLY 90 OF HIS INVESTMENT HAS BEEN IMPAIRED. THIS IS NOT A TAX RESULT LIKELY TO BE APPROVED IF THE

PARTIES EMPLOY A PARTNERSHIP, AND THERE SEEMS TO BE NO REASON TO ALLOW IT IF THE PARTIES INSTEAD RESORT TO AN S CORPORATION. A TERMINATION RULE WILL NOT WORK HERE. A SUBSTANTIAL ECONOMIC EFFECT REQUIREMENT WILL.

MOST AND PERHAPS ALL OF THE OTHER ARRANGEMENTS DESERVING ATTENTION CAN BE DIVIDED INTO TWO CATAGORIES. FIRST, THOSE THAT SHIFT CURRENT INCOME AWAY FROM SHARES, PRODUCING DEDUCTIONS AND IN SOME CASES NET LOSS FLOWING TO THE SHAREHOLDERS. SECOND, ARRANGEMENTS THAT EITHER DO NOT IMPACT ON CURRENT INCOME OR, IN THE OVERALL, SHIFT INCOME TO THE SHARES.

4. CURRENT INCOME SHIFT TO OTHER INSTRUMENTS

AS AN ILLUSTRATIVE CASE, ASSUME UNRELATED A AND B ORGANIZE A NEW S CORPORATION. A INVESTS 100 FOR 100 SHARES. B INVESTS 300 AND RECEIVES A 10 YEAR DEBENTURE WHICH PROVIDES FOR "CONTINGENT ANNUAL INTEREST" EQUAL TO 85% OF THE ANNUAL PROFITS OF THE S CORPORATION COMPUTED WITHOUT REGARD TO "INTEREST" PAYMENTS ON THE DEBENTURE AND BEFORE TAKING ACCOUNT OF ANY STATE OR OTHER TAXES ON OR MEASURED BY INCOME. AT THE END OF TEN YEARS B WILL RECEIVE BACK THE 300 INVESTED.

THE ARRANGEMENT IS FAIRLY BARGAINED IN THAT EACH INVESTOR IS FULLY COMPENSATED. A HAS SUPPLIED 25% OF TOTAL CAPITAL, WILL RECEIVE ONLY 15% OF EARNINGS DURING TH FIRST 10 YEARS, BUT THEREAFTER WILL HOLD ALL OF THE ECONOMIC INTERESTS IN THE ENTERPRISE. B HAS INVESTED 75% OF TOTAL CAPITAL, WILL RECEIVE A 10% EARNINGS PREMIUM DURING THE FIRST 10 YEARS, BUT FOR THAT

PREMIUM HAS GIVEN UP ANY CONTINUING INTEREST IN THE LONG-TERM GROWTH OF THE ENTERPRISE. WHILE THIS MAY BE A FAIR BARGAIN AS BETWEEN A AND B, IT IS NOT AN ACCEPTABLE ARRANGEMENT FROM THE VIEWPOINT OF THE FISC IF B IS A PERSON NOT ELIGIBLE TO BE A SHAREHOLDER IN AN S CORPORATION. FOR, AT BOTTOM, WHAT THE PARTIES HAVE ARRANGED IS A 15%:85% EQUITY SPLIT COUPLED WITH A REQUIRED REDEMPTION OF THE LARGER SHAREHOLDER AT AN AGREED PRICE 10 YEARS HENCE.

NOTE THAT IF THE ARRANGEMENT BETWEEN A AND B CALLED FOR ANNUAL "INTEREST" TO B OF 30 PLUS 75% OF PROFITS COMPUTED BEFORE INTEREST EXPENSE AND CERTAIN TAXES, IT COULD PRODUCE "INTEREST INCOME" TO B AND A LOSS FLOWING THROUGH TO A.

5. FLOW OF CAPITAL AWAY FROM SHARES

A INVESTS 100 IN A NEW S CORPORATION IN EXCHANGE FOR ONE SHARE. UNRELATED B INVESTS 100 RECEIVING IN EXCHANGE A 10 YEAR NOTE (FACE 100) AND A WARRANT EXERCISABLE AT 100 TO PURCHASE ONE SHARE. THE NOTE IS A STRAIGHT DEBT INSTRUMENT CALLING FOR ANNUAL INTEREST AT EITHER A FIXED RATE OR A RATE THAT VARIES WITH PRIME.

TWO SIGNIFICANT CONSIDERATIONS DISTINGUISH THIS CASE. FIRST, WHILE THE WARRANT IS OUTSTANDING NET INCOME OR LOSS FLOWS TO AN ELIGIBLE SHAREHOLDER. SECOND, THE ARRANGEMENT IS COMPREHENSIBLE AS A COMMERCIAL MATTER. CLOSELY HELD CORPORATIONS, WHETHER C OR S, QUITE REGULARLY BORROW FROM A LENDER WHO REQUIRES AN EQUITY KICKER IN THE FORM OF A WARRANT OR A CONVERSION RIGHT.

IF THE CORPORATION IN ISSUE WERE IN C STATUS, WE WOULD NOT BE TROUBLED. ASSUMING THE CORPORATION EARNED 100 AFTER INTEREST EXPENSE AND PAID CORPORATE TAX OF 40 AFTER GIVING EFFECT TO ISSUE DISCOUNT DEDUCTION, B'S WARRANT WILL INCREASE IN VALUE BY 30 IF, AS LIKELY WOULD BE THE CASE, THE CORPORATION IS PROHIBITED FROM DISTRIBUTING DIVIDENDS TO A SO LONG AS THE NOTE IN FAVOR OF B REMAINS OUTSTANDING. B WILL NOT BE TAXED WHEN HE EXERCISES THE WARRANT. DISREGARDING ISSUE DISCOUNT, THE RESULTS WOULD BE THE SAME IF B RECEIVED A CONVERTIBLE NOTE RATHER THAN A STRAIGHT NOTE AND SEPARATE WARRANT.

WHEN THE CORPORATION IS IN S STATUS THERE IS A DIFFERENCE. SHAREHOLDER A AND NOT THE CORPORATION PAYS TAX ON THE NET EARNINGS. IF THE ARRANGEMENT CALLS FOR A DIVIDEND DISTRIBUTION TO A APPROXIMATING THE 40 OF CORPORATE TAX THAT WOULD BE INCURRED UNDER A C REGIME, THERE IS NO PROBLEM. BUT IF THE ARRANGEMENT OVERLY RESTRICTS OR PROHIBITS DIVIDEND DISTRIBUTIONS, UNDER THE S REGIME THE VALUE OF B'S WARRANT WILL INCREASE SUBSTANTIALLY MORE THAN WOULD BE THE CASE WERE THE CORPORATION IN C STATUS. THIS IS THE NUB OF THE PROBLEM, ONE THAT TAKES ON AN UNATTRACTIVE CAST IF A IS IN A VERY LOW BRACKET OR ENJOYS A NET OPERATING LOSS CARRYOVER, AND A THOROUGHLY UNWHOLESOME APPEARANCE IF IN ADDITION THE WARRANT OR CONVERSION RIGHT IS EXERCISABLE TO ACQUIRE A VERY HIGH PERCENTAGE OF THE CORPORATION'S STOCK.

ARRANGEMENTS THAT CONTEMPLATE A SHIFT OF CAPITAL AWAY FROM S CORPORATION SHARES, THEN, WHILE COMMERCIALLY NORMAL AND USUALLY INOFFENSIVE, DO CARRY THE POTENTIAL OF A SPECIFIC, IDENTIFIABLE TAX AVOIDANCE.

C. DEVELOPING A STATUTORY APPROACH

THE SECTION 385 REGULATIONS, DESIGNED FOR APPLICATION IN A SUBCHAPTER C WORLD, CANNOT BE TRANSLATED INTACT TO THE SUBCHAPTER S WORLD. AS EARLIER NOTED, PROPORTIONATE HOLDING OF STOCK AND DEBT IS A FOCUS OF CONCERN UNDER THE SECTION 385 REGULATIONS, A NON-PROBLEM IN THE S REGIME.

BUT THE SECTION 385 REGULATIONS ARE RELEVANT TO SUBCHAPTER S ISSUES IN SOME RESPECTS. FIRST, THE REGULATIONS WITHOUT DOUBT ARE IMPLICATED WHEN A CORPORATION SHIFTS FROM C TO S STATUS, AND PRESENT A SET OF PROBLEMS TO WHICH I WILL RETURN LATER. SECOND, SOME CLASSIFICATIONS DEVELOPED IN THE REGULATIONS CAN BE USED TO ADVANTAGE UNDER EITHER SUBCHAPTER.

1. INCOME DIVERSION

WHEN AN EQUITY ATTRIBUTE OF A HYBRID INSTRUMENT IS A YIELD FEATURE -- "INTEREST" SET AS A PERCENTAGE OF THE GROSS OR NET PROFITS OF THE CORPORATION OR A DIVISION OR SUBSIDIARY -- A RESPONSE IS CALLED FOR.

-- ONE POSSIBILITY IS TERMINATING THE S ELECTION IF, AT ANY TIME, THE INSTRUMENT IS HELD BY A PERSON INELIGIBLE TO BE A SHAREHOLDER. CONSISTENCY, I BELIEVE, SUGGESTS THAT AN

ELIGIBLE HOLDER'S CONSENT TO THE S ELECTION BE REQUIRED, AND THAT THE NUMBER OF SHAREHOLDERS LIMIT BE CONVERTED TO A NUMBER OF EQUITY INSTRUMENT HOLDERS LIMIT.

-- A SECOND APPROACH WOULD LOOK TO THE PORTION OF THE SECTION 385 REGULATIONS THAT CLASSIFIES HYBRID INSTRUMENTS, NOT HELD PROPORTIONATELY TO SHAREHOLDINGS, AS DEBT OR EQUITY. WITHOUT REGARD TO WHETHER A PARTICULAR HOLDER IS ELIGIBLE TO BE A SHAREHOLDER OR IN FACT IS A SHAREHOLDER IN THE S CORPORATION, S STATUS WOULD BE UNAVAILABLE IF THE HYBRID INSTRUMENT, UNDER THE SECTION 385 REGULATIONS, WOULD BE CLASSIFIED STOCK WHEN HELD BY A NONSHAREHOLDER.

-- A THIRD APPROACH WOULD IMPOSE BOTH DISQUALIFICATION RULES. IF EITHER TEST IS FAILED THE S ELECTION TERMINATES.

MY OWN PREFERENCE IS FOR THE SECOND OF THESE, A TEST KEYED NOT TO THE HOLDER BUT TO THE HYBRID INSTRUMENT AND THE PERTINENT SEGMENT OF THE SECTION 385 REGULATIONS. MY FOCUS ON THE REGULATIONS IS DEFINITIONAL ONLY, AND I WOULD ADOPT THE CONCEPT WHETHER OR NOT THE SECTION 385 REGULATIONS ARE MAINTAINED IN SUBCHAPTER C. I RECOGNIZE THAT OTHER APPROACHES ARE AVAILABLE, FOR EXAMPLE, PRESERVATION OF THE S ELECTION WHILE TREATING THE HYBRID INSTRUMENT AS IF IT WERE AN INTEREST IN A PARTNERSHIP VENTURE JOINTLY CONDUCTED BY THE CORPORATION AND THE HOLDER. BUT, ON BALANCE AND NOT WITHOUT RELUCTANCE, I HAVE COME TO CONCLUDE THAT THE AUDIT BURDEN OF THAT APPROACH OUTWEIGHS EVEN THE SIGNIFICANT ADVANTAGE OF

PRESERVING THE S ELECTION. I HAVE REACHED THIS CONCLUSION IN LARGE PART BECAUSE I DO NOT BELIEVE THAT S CORPORATIONS ORDINARILY ISSUE HYBRID YIELD INSTRUMENTS OF THIS SORT, AND LITTLE OTHER THAN THE PROSPECT OF SPECIAL TAX AVOIDANCE WOULD MOVE THEM TO DO SO IN THE FUTURE.

2. WARRANTS, CONVERTIBLES, AND THE LIKE

THE SECTION 385 REGULATIONS DO NOT SPEAK TO WARRANTS BUT DO CHARACTERIZE CONVERTIBLE INSTRUMENTS AS STOCK IN DESCRIBED CIRCUMSTANCES. THAT PORTION OF THE REGULATIONS SHOULD HAVE NO APPLICATION IN THE SUBCHAPTER S CONTEXT. THE PENALTY OF DISQUALIFICATION IS OVERWHELMING AND INAPPROPRIATE.

TWO CONSIDERATIONS LEAD TO THIS CONCLUSION. FIRST, S CORPORATIONS ISSUE WARRANTS, CONVERTIBLE INSTRUMENTS, AND THE LIKE FOR BUSINESS REASONS. SECOND, THE POTENTIAL OF TAX AVOIDANCE IS NARROW, AND APPEARS TO RESIDE EXCLUSIVELY IN COLLATERAL ARRANGEMENTS UNDER WHICH THE CORPORATION ACCUMULATES SUBSTANTIALLY MORE THAN IT WOULD UNDER SUBCHAPTER C. NOTHING IN NEARLY A QUARTER CENTURY EXPERIENCE WITH SUBCHAPTER S HAS SUGGESTED THIS IS A REALISTIC PROBLEM. IF A RESPONSE TO THE FEAR OF A FUTURE PROBLEM IS NEEDED, IT OUGHT TO FOCUS ON THE TAX TREATMENT OF THE HOLDER WHEN THE WARRANT OR CONVERTIBLE IS EXERCISED OR REDEEMED.

D. SHIFT FROM C TO S

ASSUME MR. A, SOLE STOCKHOLDER OF A C CORPORATION WITH ACCUMULATED EARNINGS AND PROFITS IN EXCESS OF 100, ALSO HOLDS A

LONG-TERM NOTE OF 100 WHICH HE ACQUIRED FROM THE CORPORATION FOR THAT SUM. ASSUME FURTHER THAT, UNDER THE SECTION 385 REGULATIONS (THE CORPORATION FAILED TO PAY INTEREST TIMELY) OR UNDER THE CASE LAW IF THOSE REGULATIONS ARE INAPPLICABLE, THE NOTE IN THE C CORPORATION WORLD IS CLASSIFIED STOCK. MR. A MAY OR MAY NOT BE AWARE OF THIS. IN 1984 THE CORPORATION ELECTS S STATUS AND, UNDER THE REGIME OUTLINE ABOVE, THE NOTE IS NOT CLASSIFIED A SECOND CLASS OF STOCK.

IF THE CORPORATION ELECTS TRACK I, ON ANY ANALYSIS OF THE CASE THERE SHOULD BE NO PROBLEM. THAT ELECTION EXPUNGES ACCUMULATED EARNINGS AND PROFITS. IF THE SHIFT TO SUBCHAPTER S IS TREATED AS A RECAPITALIZATION OF C EQUITY INTO S DEBT, A WILL INCUR NO TAX LIABILITY.

IF, HOWEVER, THE CORPORATION ELECTS TRACK II, A MAY INDEED ENCOUNTER A TAX PROBLEM. IF THE TRANSACTION IS VIEWED AS THE TRANSLATION OF STOCK INTO DEBT, A WILL BE CHARGED WITH A DIVIDEND OF 100. THAT SEEMS AN EXTRAORDINARY PENALTY, PARTICULARLY SO IF MR. A, NOT PRIVY TO THE BEST TAX ADVICE, WAS NOT AWARE HIS NOTE HAD CEASED TO BE A DEBT INSTRUMENT SOME TIME AGO.

-- ONE POSSIBILITY IS TO APPLY THE "LIFE IS UNFAIR" APPROACH AND IMPOSE THE DIVIDEND TAX.

-- A SECOND POSSIBILITY WOULD PRESERVE DIVIDEND CHARACTER BUT DEFER THE INCOME UNTIL A EITHER REDEEMS OR SELLS THE NOTE. THIS WOULD BE A SECTION 306 APPROACH AND WOULD REQUIRE A STATUTORY CHANGE.

-- A THIRD APPROACH WOULD, IN EFFECT, TREAT THE NOTE AS NON-STOCK FOR SUBCHAPTER S QUALIFICATION PURPOSES, BUT AS STOCK FOR PURPOSES OF SECTION 302. REPAYMENT OF THE NOTE WOULD GIVE RISE TO DIVIDEND TREATMENT, ASSUMING ADEQUATE ACCUMULATED EARNINGS AND PROFITS, BUT SALE OF THE NOTE TO A THIRD PARTY WOULD NOT. STATUTORY CONFIRMATION WOULD SEEM IN ORDER.

-- A FOURTH POSSIBILITY WOULD TREAT THE NOTE AS A DEBT INSTRUMENT FOR ALL PURPOSES, BUT WOULD HOLD THAT THE "AUTOMATIC RECAPITALIZATION" OF A C EQUITY INSTRUMENT INTO AN S DEBT INSTRUMENT IS A TAX FREE EXCHANGE IN WHICH BASIS IS PRESERVED. AGAIN, STATUTORY CONFIRMATION WOULD BE REQUIRED.

ON BALANCE, I FIND THE FIRST POSSIBILITY OPRESSIVE, THE FOURTH PREFERABLE, AND EITHER OF THE OTHERS MARGINALLY ACCEPTABLE. THE FOURTH IS UNCOMPLICATED AND BEST PROTECTS THE ILL-ADVISED. IT CAN BE CRITICIZED AS PERMITTING AN END RUN AROUND THE DAVIS CASE (397 U.S. 301), BUT DAVIS SEEMS TO ME AN UNATTRACTIVE DECISION AND TO LIMIT ITS SCOPE, IN THE CIRCUMSTANCES HERE CONSIDERED, WOULD VIOLATE NO IMPORTANT TAX POLICY.

VI. FOREIGN INCOME

THE THIRD ISSUE ON WHICH COMMENT HAS BEEN REQUESTED IS WHETHER THE CURRENT LIMITS ON THE FOREIGN INCOME OF AN S CORPORATION ARE APPROPRIATE.

WHATEVER REASONS THERE MAY HAVE BEEN TO IMPOSE A FOREIGN INCOME LIMIT UNDER OLD LAW SUBCHAPTER S, AND IT IS DIFFICULT TO IDENTIFY ONE, THERE WOULD SEEM TO BE NO REASON TO IMPOSE ANY SUCH LIMIT UNDER THE PASSTHROUGH REGIME NOW PROPOSED.

Chairman **Stark**. I must say, Professor, you make it all sound easy. I guess I would ask each of you, Don, you have commented on Mr. Ginsburg's proposal. Should somebody get capital gains when otherwise they would get ordinary income? Why not base it on ordinary income?

Mr. **Ginsburg**. May I take that one as addressed to a partial parent?

Chairman **Stark**. Yes, please; and I would ask each of you. Go ahead.

Mr. **Ginsburg**. I think that is probably the single most significant question that can be asked of the proposal, that is, it is merely pragmatic, lots of people will like it, or is there a conceptual underpinning for it.

Chairman **Stark**. I am assuming that the difference would be 20 percent over 5 years, or 50 percent over 5 years, and that the 5 years is a delightful advantage in itself.

Mr. **Ginsburg**. No question. I would like to respond to it two ways; narrowly and then, as first invited, conceptually.

Narrowly, I don't think in the real world the comparison is between a distribution of something that approximates earnings and profits at capital-gain rates or at ordinary income rates, because this assumes that closely held corporations will, in fact, distribute dividends of all or a large part of their earnings and profits.

In fact, they don't. They do almost everything they can to avoid that distribution. And so I think the comparison more accurately is between getting a capital-gain tax on something that approximates earnings and profits over 5 years, and either getting it much later when the shareholders sell out for capital gain, or never getting it at all if they hold the shares, live not quite forever and ultimately expire blessing their heirs with the benefits of a stepped-up basis.

I think conceptually there is a more rounded way to look at it, and perhaps with your indulgence I can offer an example. Let's assume that years ago Mr. A organized a corporation under subchapter C. He invested $100. The corporation prospered. It earned money, paid its corporate tax, reinvested the earnings, borrowed money in order to acquire more assets, and its current configuration is something like this. It has assets with a basis of a thousand, and the assets having appreciated in value over time are worth $2,000.

Its liabilities are $500. That is what it owes the banks and trade creditors. The shareholder investment is still $100 and the accumulated earnings and profits are $400, so the tax balance sheet is basis $1,000 on one side and an aggregate of shareholder investment, liabilities, and earnings and profits of $1,000 on the other side.

If this enterprise liquidates under section 331, the foremost impact of that liquidation, as Mr. Glickman pointed out this morning, is to lift the burden of the corporate tax from the stream of future earnings generated by the business and assets of the corporation.

Thus, no more tax at the corporate level, with some hope that there now will be tax at the shareholder level. As Mr. Glickman pointed out, subchapter S does the same thing. The S election lifts the burden of the corporate tax off of that stream of future earnings.

I suppose that is why the two things—the real liquidation and the subchapter S election—are often said to be comparable. There is, however, much more to it. The subchapter S corporation's asset basis remains $1,000. If the corporation had in fact liquidated, asset basis would have been stepped up to $2,000, fair market value. Thus, a $1,000 increase in asset basis.

Now, that is very valuable. If it is inventory that we are stepping up, the shareholder now in possession of the inventory can sell it tomorrow and there is no further tax. If it is depreciable property, there will be a stream of depreciation deductions over time, and under present tax rules that time gets shorter and shorter.

On the other hand, there is a tax to pay by virtue of the liquidation, capital gain at the shareholder level and ordinary-recapture tax at the corporate level on depreciation and the like. Hence, in a liquidation the valuable comparison is between the cost of the current tax burden, the shareholder capital gain and the corporate-level recaptured taxes, on the one hand, and the present value of the future tax benefits that will flow from that $1,000 asset-basis step-up on the other hand.

Now, the balance of the tax cost and the tax benefit, the present value of the future tax benefit, is particular to each corporation. It is different in every case. But, under current rules and rates, if you view things from the perspective of the FISC, of the system as a whole, it seems fair to conclude that across the board there is a fair balance between the aggregate cost of a fully taxable liquidation and the aggregate present value of the future tax benefits that arise from the asset-basis step-up; that is, the liquidation tax cost is compensated by the $1,000 asset-basis step-up and vice versa.

That is a fairly good generalization. In some companies, the present value of the benefits is much greater and in some cases it is less, but across the board, it is a pretty good balance.

Recalling the liquidation analogy and recognizing that a subchapter S election is identical to a liquidation in the paramount sense of lifting the burden of the corporate tax, I think we can focus more exactly on the one great difference.

From a systemic viewpoint, the subchapter S nonstep-up of $1,000 in asset basis is balanced by the nontaxation of $1,000 of the total $1,400 gain at the shareholder's level and nontaxation of corporate level recaptures. What we have not taken account of is a $400 discontinuity.

If the shareholder had liquidated, his gain on my numbers would have been $1,400. Assets of $2,000 less $500 of liabilities is $1,500 and, less his basis of $100, leaves him with a $1,400 gain. Not a $1,000 gain.

This is the same $400 which, absent a real liquidation, continues to be reflected in the basis of the assets at the corporate level, due to the corporation's reinvestment of its accumulated earnings and profits. That is the $400 piece we ought to be taxing because, when Mr. A goes to subchapter S, what now becomes "his" basis in the assets, for purposes of future depreciation and the like, is not $600, the sum of his investment of $100 and the liability of $500, but rather is $1,000 because he is getting directly the benefit of the reinvested accumulated earnings and profits.

Thus, the liquidation analogy brings us to conclude that $400 is the uncompensated asset-basis advantage in an S election. That $400 ought to be taxed to the shareholder as capital gain. Not because it is convenient, expedient, and looks good, but because conceptually that is the proper tax under a liquidation analogy.

There is more to it that one could get into, focused in part by Mr. Alexander's earlier comments, but I think I have more than exhausted the chairman's patience.

Chairman STARK. Not my patience. You may have confused me a little. Let's work back up the line.

Mr. ALEXANDER. It has been so long since you asked the question, I have forgotten what it was. Would you repeat it?

Chairman STARK. Basically, I was trying to determine why the penalty toll tax shouldn't be based on ordinary income, or the corporate rate, other than the capital gain rate.

Mr. ALEXANDER. I think you raise two questions there, Mr. Chairman. First is, it goes to the toll charge and this rough equivalence that the professor has spelled out for you. The second goes to whether this is a bailout.

I repeat my view—and I have run the arithmetic—that the proposals suggested to you today would undermine our unintegrated corporate tax system for small corporations.

Mr. Chairman, I have represented a few small corporations and am a stockholder in a family corporation, and it pays some dividends. It has to because some of us are not working there. The suggestion that all small corporations pay no dividends is not real. What this would do would be permit a corporation to strip its earnings, accumulate them for 5 years, then strip them for 5 years.

It has been suggested this is the equivalent of a straight liquidation. It is not. This is not a liquidation. The earnings remain in corporate solution. There is no step-up in basis. The assets are not available to the stockholders. They don't belong to the stockholders. They belong to the corporation.

It has been suggested that the corporation can liquidate, reincorporate and therefore it is no bailout. That is downright silly. As you know full well, corporations have lease agreements, they have loan agreements, corporations have other contractual relationships and very few, if any of those, are assignable without consent of an adverse party.

Corporations don't go around liquidating with a view toward reincorporating unless they are more interested in their tax situation than they are in continuing in business. This whole idea, I repeat, is using a sledge hammer to kill an ant.

Chairman STARK. Mr. Shapiro?

Mr. SHAPIRO. Thank you, Mr. Chairman. As Professor Ginsburg said, if we were going to start and draft a bill from scratch, we would be doing it in the context of what would be appropriate for partnerships and corporations in general.

Should we look at the basic concepts across the board? However, we are not there. We are at the point where we are trying to adopt a simplification process for subchapter S recognizing that we are modeling after the partnership rules, but in some cases continuing corporate-type rules.

Conceptually, it doesn't always work in the best way from the standpoint of treating a business entity as it would have been treated in other modes.

First of all, as you indicated, if a corporation distributes dividends which represent E. & P., the shareholders will be taxed on the dividends at ordinary income rates. If a shareholder sells the stock, as you pointed out, any gains will be treated as capital gains. The E. & P. that is associated with the appreciation of the stock, will receive capital gain treatment when the stock is sold. If the corporation should liquidate, then the amount of the E. & P. at the point of liquidation dividends would also be treated as a capital gain.

The question that comes out now is, the analogy if the corporation were to liquidate and set up a partnership. There would be a capital gain tax in order to get in a partnership form and avoid the double tax.

Corporations prefer not doing this for the simple reason that if they have elected corporate status not necessarily for tax purposes but for business purposes, that is the limited liability of their shareholders, the shareholders want their liability limited and the protection of the corporate status.

There are benefits, as Mr. Nolan indicated, of a corporate status from a tax point of view even with a double tax on dividends.

One advantage is the fact that there are lower tax rates on the first $100,000 of income. If you want to reinvest in the corporation, you can reinvest at very low rates. There are some tax shelters that are being done in the corporate mode by taking out the income as wages or salaries and what you don't need, you can avoid the 50 percent individual top tax rate by leaving the profits in the corporation at lower tax rates and thus investing through the corporation.

There is some limit against this under the accumulated earnings tax rule, but that is at a higher level and you have to establish it for a business purpose.

Chairman STARK. How real is the shelter from liability to small corporations? I can't believe that in the startup corporations or small ones that the liability isn't almost the same as a partnership. If anybody is going to lease to a corporation, they wouldn't do anything else unless the stockholders guarantee——

Mr. SHAPIRO. I am talking about limiting liability of shareholders against business, not tax, risks, such as damages. If you are in a business and an individual comes in and some harm falls on that individual, the corporation is liable but generally not to the shareholders. That is not the case in a partnership where the partners are generally liable on all aspects of the partnership.

From the standpoint of financial matters, whether it is a partnership or not, the shareholder in a small closely held corporation usually will have to sign for every loan that is being made, so there will be personal guarantee from a financial point of view.

But from the standpoint of other risks, especially if you are on the premises or not on the premises, a shareholder of a corporation has a certain protection against risks which in many businesses that incorporate can be very important, depending on the business, of course.

If it is purely a personal service business, it is not as important because you could be sued in your individual capacity for whatever service. But if it is a business, a service station for example, where there can be some damage from a personal point of view, depending on insurance coverage, you are protecting yourself in that capacity.

Let me cover one last aspect relating to your question, Mr. Chairman. Focusing on a longer term situation, as has already been pointed out, subchapter S is pure integration of individual and corporate taxation for small businesses. The question is raised, as Dave Glickman said on behalf of the Treasury, should you consider to have integration on a total concept.

Chairman Ullman explored that in the late seventies, and developed a partial integration scheme to avoid the double tax on dividends by treating the shareholders as having paid the portion of tax the corporation paid in the form of a credit to the individual shareholder for the taxes paid by the corporation.

Some have suggested that in time subchapter S will be expanded to get to a pure integration so you will not have any double tax of corporate incomes. The problem is that now we have partnership taxation, corporate taxation, and the subchapter S hybrid.

Dealing with the conceptual problems that you raise, Mr. Chairman, between ordinary income taxes and capital gains taxes, it is very difficult to look only at a conceptual basis because of the differences between corporation, partnership, and subchapter S tax rules.

Chairman **Stark**. Mr. Thomas?

Mr. **Thomas**. Your question made me think of the first experience I had with subchapter S, which I guess is how I got to be our firm's specialist.

About 20 years ago a consulting engineering firm that was expanding worldwide was forced into the corporate form because they were expanding, and the principal partner at that time said he did not want his own personal fortune at risk for what some salaried engineer may do in Thailand. There were many disadvantages to the corporate form from a tax standpoint, but the business choice rolled them into it, and subchapter S was the best we could do.

In getting to this capital gain thing, I would like to try to answer it a little differently. The bill as it is drafted will not permit corporations to distribute the earnings and profits tax free. If they are distributed, they would be taxed as an ordinary dividend.

The toll charge suggestion bothers me. It is fine to make it elective, but I think almost any corporation would have to make the election in order to protect itself against an unplanned series of events down the road, where for various reasons their business might drop off and they have a little bit of interest income.

I don't think I could tell any clients, "Forget this election, you don't have to worry about it because you are an operating business." Making the election also forces the distribution of money to shareholders that have no money to pay the tax. That may work an operating hardship on the company. More often than not, the reason the money is still in there is because they need it in the corporation. It is usually not money, it is usually in nonliquid assets.

I think from a practical standpoint the idea would create some real hardships on a company that would be affected; that would be the result of the proposed election.

We talk about the comparability of subchapter S to an actual liquidation. As Mr. Alexander pointed out, one of the big differences is that the assets are not distributed to the shareholders. They don't own them individually. They are not each free to go off in their own direction. The assets are still in the corporation, and are still subject to that.

Normally when a corporation does liquidate, if the assets are significant operating assets, they are sold first because it is kind of foolish for 15 people to own a one-fifteenth interest in a factory. If it is strictly investment assets, it is a different animal.

In many cases, unless the potential tax benefit of the step-up is very short lived, you just don't come out ahead economically. Why pay tax today in order to get a deduction over 5, 10, or 15 years, if it doesn't make you any money?

As we have suggested earlier, the potential problem seems to me to be that entity that would sell its operating assets and sit there, whereas it might otherwise liquidate under present law.

I believe we should create a retroactive period, because I think we need a reasonable period of time where a company that is really changing its business can get geared up and operating, and it might have some investment income in the meantime. In those situations there would be a retroactive termination and taxation as a personal holding company, rather than imposing this burden on everybody.

Chairman STARK. Thank you very much. I appreciate the panel's indulgence. We will have additional questions for you.

[The following was subsequently received:]

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COMMITTEE ON
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WAYS AND MEANS

June 18, 1982

Mr. John J. Salmon
Chief Counsel
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D. C. 20515

Dear Mr. Salmon:

We would like to submit the following comments on H.R. 6055, the "Subchapter S Revision Act of 1982", in addition and supplemental to our oral testimony and written statement presented at the hearing held by the Subcommittee on Select Revenue Measures on June 14, 1982. These comments also express only the views of the Firm and are not made on behalf of our clients.

We also want to correct a technical error in the written statement presented at the hearing. In the section on page seven titled, "Non-Refundable Credits Available to Offset The Alternative Minimum Tax," the correct reference on the first and last lines is "Section 55(c)(2)", rather than "Section 57(c)(2)."

The oral and written statements presented at the hearing concern us for the following reasons:

- The emphasis on the theoretical liquidation effect of an S corporation election may overshadow the other very important areas of Subchapter S which require serious consideration and improvement.
- There are major practical, business and economic effects of any proposal to levy a tax at the time of an S corporation election, and we urge full consideration of all points of view. The question of inherent possibility for tax avoidance or abuse is raised without allusion to any specific examples. In the absence of serious, practical study and discussion of the matter, legislation that treats an S corporation election as a "de facto" liquidation may result by default, causing unintended harm to many small businesses.

Theoretical Liquidation

A major issue is clearly the question of whether there should be a tax cost imposed on a C corporation that elects S corporation status. The "Description of H.R. 6055: Subchapter S Revision Act of 1982" prepared by the staff of the Joint Committee on Taxation, dated June 8, 1982, addresses this matter on pages 25 and 26. Analogies are drawn there that are not realistic. An S corporation election cannot be likened to the actual liquidation of a corporation.

The assets of a liquidating corporation are physically and legally transferred to the shareholders, who pay a tax on recognized gain and take the liquidating fair market value of the assets as their tax basis. If the assets are primarily of an investment nature, the assets themselves are usually distributed pro rata or partitioned among the shareholders. An operating company, on the other hand, will usually sell the operating assets, pay its liabilities, and distribute the remaining proceeds to its shareholders, liquidating under Section 337. It is impractical to distribute undivided interests in operating assets except where the business operation will continue in a partnership. In any case, each shareholder has actual ownership and control of his/her respective share of the corporate assets, and is free to do with them whatever he/she may want.

An S corporation election does nothing to affect asset ownership; the assets remain in corporate solution and the tax basis of the assets does not change. The only change is taxation of the income from the business directly to the shareholders rather than to the corporation, which is, after all, the purpose of Subchapter S.

A closely-held corporation considering liquidation followed by continued operation of the business in any form must consider the following:

1. Liquidation in order to operate as a partnership is financially attractive only if the step-up in asset basis to fair market value applies principally to assets for which the cost will be recovered against income in the very near future, such as inventory, receivables, assets with very short ACRS or amortization lives, etc. There is no economic benefit to a current capital gains tax which is larger than the present value of the tax benefit of the step-up.

2. A plan to liquidate a corporation and distribute assets to the shareholders, with the shareholders paying the capital gains tax and then contributing some or all of the assets to a new corporation at the stepped-up basis, will not work. The Internal Revenue Service has consistently won cases classifying such transactions as tax-free reorganizations under either Section 368(a)(1)(D) or 368(a)(1)(F). The results are (1) no step-up in basis and (2) any cash or other assets retained taxed as an ordinary dividend to the extent of accumulated earnings and profits of the "liquidated" corporation.

A reference to Section 333 (the "one month" liquidation) in the Joint Committee explanation seems misleading. Regardless of other considerations, the major factor in such liquidations is low accumulated earnings and profits. A Section 333 liquidation may then be attractive for a corporation with appreciated assets and low liquidity. Given a corporation that is a candidate for a Section 333 liquidation and also qualifies for Subchapter S, we believe the liquidation to be the better choice in nearly every case. We can find nothing here to indicate any support for treating an S corporation election as a liquidation.

Testimony at the hearing indicates concern over the step-up in basis of stock at death, which, as pointed out several times, is not unique to S corporations. The beneficiaries of a shareholder of any C or S corporation benefit from the step-up in basis at death. The stock may be redeemed from the estate or beneficiaries of that shareholder at no income tax cost under existing law. The S corporation rules do not and will not provide any unique opportunity for tax benefit in that area.

Passive Investment Income

The retention of the passive investment income limitation in restricted form may become inextricably linked to the theoretical liquidation issue, as though they are one and the same. They are not. The Joint Committee report describes the specific concern leading to the proposal on page 28. We believe our recommendation, beginning on page 13 of the written statement presented at the hearing, is an effective, practical alternative. Our proposal is directed specifically at the potential for abuse without affecting the many legitimate, operating businesses that could be trapped by the proposal in the Bill regardless of lack of intent to convert to an investment vehicle.

The elective "toll charge" proposed by Professor Ginsburg, and apparently accepted as reasonable by some others, is neither practical nor equitable. A C corporation converting to S corporation status could elect to incur the toll charge, pay capital gains tax on one-fifth of the calculated amount each year for five years, and thereby "purge" itself of accumulated earnings and profits and exposure to the passive investment income limitation. A corporation having accumulated earnings and profits that chose not to incur the toll charge would remain subject to the passive investment income test.

The proposal is unduly complex; the length of Professor Ginsburg's written statement is the best testimony of that and the difficulty in drafting any such rules. We also believe a glaring weakness of the proposal is the absence of definition of any specific opportunity for tax avoidance other than the aforementioned conversion from operating to investment status. There are hints at such possibilities that may generate an impression of potential problems, but, upon careful consideration, they are only shadows in the night. There are severe practical problems, however, which must be considered:

1. The toll charge would, in fact, not be elective. No corporation could afford to pass up the election and risk loss of S corporation status at some unknown point in the future when passive investment income might exceed 20% of total gross receipts for reasons beyond its control and which could not possibly be anticipated at the date of the S corporation election. The following illustrations show how easily that could happen:

   - o Mr. Bobby F. McKown, who appeared on behalf of Florida Citrus Mutual, testified that many citrus growers operating as Subchapter S corporations are in danger of losing their elections. The 1981 and 1982 freezes damaged so much of the crop that operating gross receipts will be very low. The passive investment income limitation may cause termination of many elections.

   - o A construction company may experience a taxable year with little or no gross receipts from operations because of a severe downturn in the construction industry, with no jobs in process to generate gross receipts under any method of accounting. A company with the financial strength to survive the current housing slump, for example, would have available working capital invested in interest-bearing deposits until activity picks up.

   - o Any company able to accumulate working capital to see it through a rough period would be in danger. Sound business practice dictates investment of working capital in a manner that permits immediate access to the funds as well as earning income while the funds are not required in the business. Investments satisfying both criteria will always generate passive investment income.

2. The toll charge mandates actual distributions by the corporation so the shareholders can pay the tax. This may cause a serious liquidity problem for corporations with most of their assets invested in non-liquid areas. A construction company required to make such distributions would experience a significant reduction in its bonding capacity, which in turn reduces the size of construction jobs on which the company may bid.

The toll charge would require legislation to prohibit election in and out of S corporation status in order to withdraw accumulated earnings and profits at long-term capital gains rates. The definition of a guilty taxpayer could only include any corporation that elects S corporation status, elects to pay the toll charge, and then terminates the S corporation election after five years or less. There is no practical way to gauge the intent of the shareholders, so it seems likely that any restrictions must operate on the theory that such a corporation is guilty unless it can prove its innocence.

The favorable comments made by others on the toll charge, or modified liquidation tax, are consistent in their failure to appreciate the complexity of the proposal or understand the actual economic and business effects of that proposal on a corporation considering an S corporation election.

Other Matters

We support the following recommendations submitted by other witnesses at the hearing:

- Opposition to the proposal for application of partnership rules to fringe benefits for certain shareholder-employees. There is a real difference between the status of a shareholder who is also an employee and a partner who renders services to the partnership. Existing law includes adequate safeguards against abuse of the fringe benefit area, and the treatment of shareholder-employees of an S corporation should be no different than that of shareholder-employees of any other closely-held corporation.
- Treatment of undistributed taxable income as income in respect of a decedent subject to Section 691. This is consistent with the fact that such income is generally included in determining the fair market value of the stock for estate tax purposes.

Conclusion

We appreciate the opportunity to present our views to the Committee. We urge the members of the Committee and its staff to give thoughtful consideraton to all of the testimony and statements presented. Our hope is for a Bill that will accomplish the following objectives:

1. A true simplification of Subchapter S.
2. A clear definition of possibilities for tax avoidance or abuse with specific provisions for prevention without overkill.

We will be happy to answer any questions, furnish additional information, or discuss any matters concerning our comments.

Very truly yours,

ARTHUR ANDERSEN & CO.

By

Richard L. Thomas

DCT

Chairman **Stark**. Our next panel will be Peter McNeish, National Association of Small Business Investment Companies; Luis Granados, ESOP Association; and Bobby McKown, executive vice president and general manager of the Florida Citrus Mutual.

We appreciate you being here. Your testimony will appear in its entirety. If you would like to emphasize points of particular importance to you, we would appreciate it.

Mr. McNeish, you are first on the list. Would you like to proceed?

STATEMENT OF PETER F. McNEISH, EXECUTIVE VICE PRESIDENT, NATIONAL ASSOCIATION OF SMALL BUSINESS INVESTMENT COMPANIES

Mr. **McNeish**. Thank you, Mr. Chairman.

It is a pleasure to be here this morning. I appreciate the opportunity to testify on H.R. 6055.

I am, as you have indicated, Peter McNeish, executive vice president of the National Association of Small Business Investment Companies. These are privately organized, privately managed investment firms, licensed and regulated by the Small Business Administration under the terms of the Small Business Investment Act of 1958.

There are currently 500 SBIC's with approximately $1.7 billion in assets. The board of governors of our association has formally endorsed H.R. 6055 and has expressed the hope that subject to two suggested changes in the bill, it will receive early and favorable action by this committee.

Our first suggestion pertains to subsection (b)(1)(B) of section 1361, which provides that an S corporation shall not "have as a shareholder a person—other than an estate and other than a trust described in subsection (c)(2)—who is not an individual * * *"

Under present law and the pending bill, a small business investment company, whether incorporated or in limited partnership form, itself cannot be a shareholder in an S corporation.

Our association has long advocated a change in subchapter S to permit SBIC's to be shareholders in S corporations, primarily for the benefit of small concerns in which a SBIC might invest.

An SBIC's ability to participate in the growth and prosperity of its portfolio concerns through stock ownership is one of the principal inducements to the SBIC in providing venture capital to eligible small business concerns.

SBIC's are prohibited by regulation to take a control position in a small firm, and we believe that venture capital, noncontrolling shareholder participation conforms to the basic intent of subchapter S. We believe that an amendment to section 1361 of the bill permitting SBIC's to be subchapter S shareholders would be beneficial to small business' ability to raise venture capital.

A point not in my written testimony that I feel should be addressed is the question that was raised by the committee as to the applicability of the section 385 regs to distinguish debt from equity in the determination of class ownership qualifications.

Our association's response to that issue is a resounding "No." The 385 regulations should not apply under subchapter S, not only for the reasons previously stated by other witnesses but also because of the torturous regulations now proposed by the Treasury Department.

The 385 regs are, No. 1, unfairly complex in form and unworkable. In addition to being 53 pages in length, they are fraught with variable formulas, safeguards and multiple guidelines; they are not intelligible; they are very difficult to work with; and they will, in our judgment, drive venture capital away from small business and drive many small businesses out of business.

The second exception, the change we suggest in the proposed legislation, relates to the subchapter S passive income test. The subchapter S proposal provides for termination of an election "whenever the corporation (I) has gross receipts for any taxable year more than 20 percent of which is passive investment income, and (II) has accumulated earnings and profits at the close of such taxable year."

Since its original enactment in 1958, subchapter S has provided for termination of an election whenever more than 20 percent of an electing corporation's gross receipts for any taxable year consist of passive investment income, thus effectively excluding closely held SBIC's from electing under subchapter S.

We support the pending proposal to permit a continued election even where more than 20 percent of gross income is passive investment income provided the electing corporation does not have accumulated earnings and profits at the close of the taxable year.

The pending proposal will enable newly licensed SBIC's and older SBIC's which do not currently have any accumulated earnings and profits to elect under subchapter S.

But for other existing SBIC's, particularly those which are the most active and most profitable and which have significant accumulated earnings and profits, a distribution of accumulated earnings to the shareholder in order to qualify for the election would result in harsh tax consequences for the shareholders, such distributions being taxable to them at ordinary income rates.

We strongly urge the committee to amend this section of the pending bill to permit a one-time distribution of accumulated earnings and profits to the corporation's shareholders with such distributions to be taxed at capital gains rates rather than at ordinary income rates. This would allow currently active, closely held SBIC's a one-time equitable opportunity to elect under subchapter S.

Subject to those two suggestions, our association heartily endorses H.R. 6055 as a very progressive step for small business, a constructive initiative which will promote economic growth and a major step toward the simplification of tax rules and regulations that apply to small firms.

Thank you.

[The prepared statement follows:]

STATEMENT OF PETER F. MCNEISH, EXECUTIVE VICE PRESIDENT, NATIONAL ASSOCIATION OF SMALL BUSINESS INVESTMENT COMPANIES

Mr. Chairman and members of the committee, thank you for inviting me to testify today on the "Subchapter S Revision Act of 1982" (H.R. 6055).

I am Peter F. McNeish, Executive Vice President and Legislative Counsel of the National Association of Small Business Investment Companies, a trade association which represents the overwhelming majority of all Small Business Investment Companies (SBICs) and Minority Enterprise Small Business Investment Companies (MESBICs).

As you know, SBICs, are privately organized, privately capitalized and privately managed venture capital firms which provide equity capital, long-term loans and management assistance to new and growing small business concerns. SBIC's are licensed under the Small Business Investment Act of 1958 and regulated by the Small Business Administration.

The Board of Governors of our Association has formally endorsed H.R. 6055 and has expressed the hope that, subject to two suggested changes in the bill, it will receive early and favorable action by this Committee.

Our first suggestion pertains to subsection (b)(1)(B) of section 1361 which provides that an S Corporation shall not "have as a shareholder a person (other than an estate and other than a trust described in subsection (c)(2)) who is not an individual . . ."

Under present law and the pending bill, a small business investment company, whether incorporated or in limited partnership form, cannot be a shareholder in an S corporation.

Our Association has long advocated a change in Subchapter S to permit SBICs to be shareholders in S corporations, primarily for the benefit of small concerns in which SBICs invest. An SBIC's ability to participate in the growth and prosperity of its portfolio concerns through stock ownership is one of the principal inducements to the SBIC in providing venture capital to eligible small business concerns.

We believe that an amendment of Section 1361 of the pending bill to permit SBICs to become shareholders in S corporations would benefit small business and accordingly we urge the Committee to consider amending the pending bill to this end.

Our second suggestion pertains to subsection (d)(3)(a) of section 1362 which provides for termination of an election "whenever the corporation (I) has gross receipts for any taxable year more than 20 percent of which is passive investment income, and (II) has accumulated earnings and profits at the close of such taxable year."

Since its original enactment in 1958, Subchapter S has provided for termination of an election whenever more than 20 percent of an electing corporation's gross receipts for any taxable year consist of passive investment income, thus effectively excluding closely-held SBICs from electing under Subchapter S.

We heartily support the pending proposal to permit a continued election even where more than 20 percent of gross income is passive investment income provided the electing corporation does not have accumulated earnings and profits at the close of the taxable year.

The pending proposal will enable newly-licensed SBICs and older SBICs which do not have any accumulated earnings and profits to elect under Subchapter S.

But for other existing SBICs, particularly those which are most active and most profitable and which have significant accumulated earnings and profits, a distribution of accumulated earnings to the shareholders in order to qualify for the election would result in harsh tax consequences for the shareholders, such distributions being taxable to them at ordinary income rates.

We strongly urge the Committee to amend this section of the pending bill to permit a one-time distribution of accumulated earnings and profits to the corporation's shareholders with such distributions to be taxed at capital gains rates rather than at ordinary income rates.

Subject to the two foregoing suggestions, our Association heartily endorses H.R. 6055.

Chairman STARK. What has been the objection to making this measure work, other than the general prohibition against any corporation?

Mr. McNEISH. As far as I know, it is the general prohibition has been the only objection.

Chairman STARK. Then you want to allow SBICs to become subchapter S?

Mr. McNEISH. That is correct. They currently have the capability of partnership or corporate formation.

Chairman STARK. They can also become registered investment companies.

Mr. McNEISH. That is correct, sir.

Chairman **Stark**. So it just gives them the passthrough—the privately held ones can't be held as an investment? Privately held SBICs cannot be treated as an investment company with a pass through?

Mr. **McNeish**. No, they can not.

Chairman **Stark**. Thank you.

Mr. Granados?

STATEMENT OF LUIS GRANADOS, COUNSEL, THE EMPLOYEE STOCK OWNERSHIP ASSOCIATION

Mr. **Granados**. Thank you.

I am Luis Granados, counsel to the ESOP Association, the national association with employee stock ownership plans. We are here today to ask to permit a subchapter S corporation to establish an employee stock ownership plan.

The ESOP is a 401 qualified plan that provides beneficial ownership of company stock to the company's employees on a nondiscriminatory basis, typically at no cost to the employees.

The rapid growth of the use of ESOP's is one of the most encouraging features on the otherwise bleak landscape. Since 1975, thanks to a series of laws passed by the Congress, thanks to the ingenuity and willingness to experiment, the growth has gone to 5,000 and that is still accelerating.

This holds great promise for the American economy. Study after study shows that when workers become owners, when it suddenly matters how the company performs, they do a better job.

It doesn't take an MBA to figure out that when the Gallup Poll shows that only 9 percent of the American work force thinks that they, the workers, benefit when the productivity improves, it is time to change things.

Even aside from their impact on productivity, ESOP's can be of great benefit to companies, particularly smaller companies, for a variety of financial advantages they offer. For example, the ESOP can be used as a way of obtaining cheap financing for corporate growth. A company can, in essence, obtain a tax deduction for its principal repayments on a borrowing by channeling the transaction through an ESOP, if the company is willing to share the fruits of growth with its employees.

The ESOP can also be used as a buyer for stock in a closely held company. The problem of business perpetuation hits vitually all small businesses at one stage of their life, and selling the company to its employees through an ESOP is always available as an option for solving this problem.

From a public policy perspective, ESOP's are of great interest because they offer a practical way of broadening the ownership of America's capital base. The stark fact is that 1 percent of Americans own over half of America's individually held capital wealth and 6 percent of Americans own over 80 percent of it.

At the other end of the scale, for a majority of Americans, their largest single asset is the entitlements they expect to receive from the social security system, a transfer payment, a promise that thier children will be taxed on their behalf.

This concentration of wealth many believe is wrong in and of itself, and it undermines the institution of private property and the system of free enterprise itself.

Those who believe, as we do, that capitalism is a good thing ought to be prepared to spread the benefits of capitalism beyond the select few who are now owners, for their own self-interest, as well as for the simple justice of it.

The ESOP is the only way to do this that does not involve redistribution from the haves to the have-nots because the ESOP focused on future capital wealth, not today's wealth.

ESOP's are good for business, they are good for workers, they are good for America, and they are growing like gangbusters. Yet with all this progress there is still one group that is on the outside looking in, and that is America's subchapter S corporations.

The fact is that no matter how clever a lawyer you hire, if you are a subchapter S corporation you cannot have an ESOP. The law is crystal clear that only certain types of trusts may be a shareholder of a subchapter S corporation, and a trust that is the principal vehicle of an ESOP is not one of them.

The question naturally arises as to why this is so. Why would Congress want to permit, even encourage, most corporations to establish an ESOP but would want to prevent absolutely a subchapter S corporation from doing so? Frankly, I don't believe there is an answer to that question.

When subchapter S was first written, there was no such thing as an ESOP, so it could not possibly have occurred to the drafters to make a provision allowing for a subchapter S corporation to establish one.

Now Congress is engaged in the process of updating the entire subchapter S law, and we are here to say that ESOP's do exist, that they are a very attractive option for business and for workers, that there is no good reason to exclude subchapter S corporations from the benefits ESOP has to offer, and that Congress ought to take account of all this when it rewrites the law.

There are some complications that arise. I have dealt with one in my statement. If the committee makes the decision that subchapter S corporations can have the same opportunities that other companies have, we would be delighted to work with the staff to do that.

Chairman STARK. Thank you very much.

[The prepared statement follows:]

STATEMENT OF LUIS GRANADOS, REPRESENTING THE EMPLOYEE STOCK OWNERSHIP ASSOCIATION

I am Luis Granados, counsel to The Employee Stock Ownership Association, which is the national trade association representing companies with employee stock ownership plans. I am here to suggest that this Committee consider an amendment to H.R. 6055, the "Subchapter S Revision Act of 1982", to permit a Subchapter S corporation to establish an Employee Stock Ownership Plan ("ESOP").

The rapid growth in the use of Employee Stock Ownership Plans is one of the most encouraging features in the otherwise bleak landscape of American business today. In 1975, there were only a handful of ESOPs in existence. Since then, thanks to a series of laws passed by Congress and the States and thanks to the ingenuity and willingness to experiment on the part of farsighted business leaders, the number of ESOP companies has grown to over 5,000—and that growth is still accelerating.

This development holds great promise for the American economy. The fact is that when workers become owners, when it suddenly makes a real difference to them how well their company performs, they tend to start doing a better job. A study by the Journal of Corporation Law last year showed that while American productivity dropped 1.5 percent over a five year period, productivity among ESOP companies *rose* 1.5 percent during the same period. A study the year before the the University of Michigan showed that profitability of ESOP companies was 50 percent higher than the profitability of similar-sized companies in similar industries.

Other studies have confirmed these results. It doesn't take an MBA, however, to figure out that when the Gallup poll shows that only 9 percent of the American workforce thinks that they, the workers, benefit from productivity improvements, it's time to start thinking about spreading the risks and rewards of capital ownership as a way to get things back on track.

Even aside from their impact on productivity, ESOPs can be of great benefit to companies, particularly smaller companies, for a variety of financial advantages they offer. For example, the ESOP can be used as a way of obtaining cheap financing for corporate growth. A company can, in essence, obtain a tax deduction for its principal repayments on a borrowing by channeling the transaction through an ESOP, if the company is willing to share the fruits of growth with its employees. The ESOP can also be used as a buyer for stock in a closely-held company. The problem of business perpetuation becomes critical for virtually all small businesses at one stage of their life, and selling the company to its employees through an ESOP is always available as an option for solving this problem. These are just two examples of the great versatility of the ESOP as a financial technique, which helps to further national goals by stimulating capital formation and by strengthening the future of small business.

From a public policy perspective, ESOPs, are of great interest because they offer a practical way of broadening the ownership of America's capital base. The stark fact is that one percent of Americans own over half of America's individually-held capital wealth, and six percent of Americans own over 80 percent of it. At the other end of the scale, for a majority of Americans, their largest single asset is the entitlements they expect to receive from the Social Security system—a transfer payment—a promise that their children will be taxed on their behalf. This concentration of wealth, many believe, is wrong in and of itself. It undermines the institution of private property and the system of free enterprise itself. When the average man gets the sense that a system is rigged and that there's really nothing in it for him, then than system faces some serious trouble. Those who believe, as we do, that capitalism is a good thing ought to be prepared to spread the benefits of capitalism beyond the select few who are now owners—for their *own* self-interest, as well as for the simple justice of it. The ESOP is the only way to do this that does not involve redistribution from the haves to the have-nots, because the ESOP focuses on *future* capital wealth, not existing wealth.

ESOPs are good for business, they are good for workers, they are good for America, and they are growing like gangbusters. Yet with all this progress, their is still one group that is on the outside looking in, and that is America's Subchapter S corporations. The simple fact is that no matter how clever a lawyer you hire, if you are a Subchapter S corporation you cannot have an ESOP. The law is crystal clear that only certain specific types of trusts may be a shareholder of a Subchapter S corporation, and a trust that is the principal vehicle of an ESOP is not one of them.

The question naturally arises as to why this is so. Why would Congress want to permit, even encourage most corporations to establish an ESOP, but would want to prevent absolutely a Subchapter S corporation from doing so? Frankly, I don't believe there is an answer to that question. The truth of the matter is that when Subchapter S was first written, there was no such thing as an ESOP, so it could not possibly have occurred to the drafters to make a provision allowing for a Subchapter S corporation to establish one. Now Congress is engaged in the process of updating the entire Subchapter S Law, and we are here to say that ESOPs exist, that they are a very attractive option for business and for workers, that there is no good reason to exclude Subchapter S corporations from the benefits ESOP has to offer, and that Congress ought to take account of all this when it rewrites the law.

There is one technical issue that has to be addressed if Subchapter S is to be amended to permit Subchapter S corporations to establish ESOPs. The ESOP trustee is the legal owner of the stock, and he or she would count as one shareholder toward the limit on the number of shareholders that a Subchapter S corporation may have (now 25, to be raised to 35). The ESOP would be one shareholder regardless of how many employees were beneficiaries of the ESOP trust. A problem could arise, at least potentially, when employees leave the company and terminate their participation in the ESOP trust. Under current ESOP law, employees are entitled to demand that their distribution be made in the form of stock, rather than in the form of the cash fair market value of the stock in their account. As a practical matter, virtually all employees of a small business company would much rather receive cash than stock, which is useless to them since they have no place to sell it. Still, there is at least the possibility that enough employees would exercise their right to demand stock to push the Subchapter S corporation over the statutory limit on the number of shareholders. To solve this problem, we suggest that language be borrowed from last year's tax bill. Section 334 of ERTA permits companies which by their charter or bylaws must be entirely owned by current employees to guarantee that they remain that way by requiring departing employees to take stock instead of cash. By taking this same language and applying it to the Subchapter S situation, the law could permit a Subchapter S corporation to remain a Subchapter S corporation by letting its ESOP distribute the cash value of stock rather than the stock itself—which is what 99 percent of employees want anyway.

Mr. Chairman, if other technical issues arise in the drafting of language to accomplish this simple purpose, our Association would be happy to work closely with you staff on them.

Chairman **Stark**. Mr. McKown?

STATEMENT OF BOBBY F. McKOWN, EXECUTIVE VICE PRESIDENT AND GENERAL MANAGER, FLORIDA CITRUS MUTUAL

Mr. **McKown**. Thank you, Mr. Chairman.

Good morning. My name is Bobby F. McKown. I am executive vice president and general manager of Florida Citrus Mutual, a voluntary cooperative trade association whose membership consists of 13,282 active Florida citrus growers.

The average cirtus grower size in the State of Florida is approximately 50 acres. So, consequently, the subchapter S corporation status is a very viable and important function and a tax mechanism that is available to many of our members and has a great deal of significance and importance for our membership.

The subchapter S category is particularly important because during 1981 and 1982 the Florida citrus industry sustained back-to-back devastating freezes. For that reason, I would like to particularly address and support item No. 3, the elimination of the requirement for the 20 percent of the gross receipts may be passive investment income, if the corporation does not have accumulated earnings and profits at the end of a taxable year.

Under present law, subchapter S election is terminated as of the beginning of any taxable year of a corporation in which more than 20 percent of its gross receipts are derived from passive sources, such as interest, dividends, et cetera.

We are aware that there is an exception to this rule for new corporations, but it has very limited practical effect because passive income is limited to $3,000 per year. Also, the exception applies to the first 2 years the corporation is in business.

Mr. Chairman, when I look at these—and in summary of my statement that I prepared for you—our people in Florida who are involved in the growing of citrus, who are involved in subchapter S corporations, today are faced with a strong potential—because of the 1981 freeze, followed by the 1982 freeze—of losing their subchapter S exemption.

We have the further understanding that there are good examples of situations where the Internal Revenue Service can waive the rule and permit this to stay in place. At first glance one might conclude that the regulation and rules noted above in my testimony eliminate the need for a change in the law, but this is not the case, however.

Second, we have no situation where the service has ruled that the election continues unbroken. In other words, there is no uncertainty as to whether the election remains intact for the year of termination.

Finally, Mr. Chairman, let me conclude and say that we suggest the proposed legislation contain no requirement that an electing farming corporation be located in a proclaimed disaster area in order to qualify for the exception. If such a provision were included, elected Florida citrus grower corporations would have received no relief from the 1981 and 1982 freezes.

I would also like to give you a first-hand illustration of the situation that some of our grower members find themselves in today, as a result of the 1981-82 freezes and as a result of the increased production of grapefruit and how their current status with their subchapter S corporation could be jeopardized.

To many of our members the results of the 1981–82 freezes caused a loss of anywhere from all to 60 percent of their production, and their farming income was less than the 20 percent required, thereby potentially jeopardizing their subchapter S corporation through an act of God, not their own election.

Additionally, grapefruit production has increased substantially over the last few years and carryover stocks doubled over the past 3 years. Many growers who sold for cash voluntarily elected to consign and/or participate their fruit in order to enhance their cash position relative to the current crop.

In other words, in many instances their fruit cannot be sold for cash at any price because of oversupply. When you go into a participation or consignment contract, you defer almost all income for at least 1 year, thereby placing our subchapter S members in jeopardy of probably losing their subchapter S status.

We support the proposed legislation, and we support the 20 percent proviso language drafted in the proposed bill.

[The prepared statement follows:]

STATEMENT OF BOBBY F. MCKOWN, EXECUTIVE VICE PRESIDENT AND GENERAL MANAGER, FLORIDA CITRUS MUTUAL

Good morning, Mr. Chairman and Members of the Subcommittee.

My name is Bobby F. McKown. I am Executive Vice President and General Manager of Florida Citrus Mutual, a voluntary cooperative trade association whose membership consists of more than 13,282 active Florida citrus growers, with headquarters at Lakeland, Florida.

Florida Citrus Mutual, on behalf of its citrus grower members, is supportive of the proposed Subchapter S Revision Act of 1982 and we believe that the proposed bill does indeed simplify the tax rules relating to eligibility for Subchapter S status and the operation of a Subchapter S corporation, particularly as they relate to the small business entities, in which category by and large Florida citrus growers are included.

Florida citrus growers are primarily small business entities and in fact, the average citrus grower in Florida represents approximately 50 acres. We believe that HR. 6055 is timely and responsive to a particular need for Florida citrus growers inasmuch as our members' income has been severely reduced because of devastating freezes in 1981 and 1982. Florida Citrus Mutual supports the changes in eligibility restrictions which the bill would make, including the following:

1. Increasing the number of permitted shareholders from 25 to 35; however, this will not have a great impact upon Florida citrus growers;

2. Permitting differences in voting rights in common stock;

and most importantly,

3. Eliminating the requirement that not more than 20% of the corporation's gross receipts may be passive investment income, if the corporation does not have accumulated earnings and profits at the end of a taxable year.

We are pleased to comment on No. 3 listed above, in particular concerning involuntary terminations of the Subchapter S election by farming corporations. We strongly support this proposal and your efforts in this regard.

Under present law (Section 1372(e)(4)) Subchapter S election is terminated as of the beginning of any taxable year of a corporation in which more than 20% of its gross receipts are derived from passive sources, such as interest, dividends, rents, etc. Although we are aware there is an exception to this rule for new corporations, it has very limited practical effect because passive income is limited to $3,000 per year. Also, the exception applies only to the first two years the corporation is in business. This exception is provided in Section 1372(e)(5)(B) of the Code.

Section 1372(f) of the law provides that if the Subchapter S election is terminated or revoked, either voluntarily or involuntarily, a new election cannot be made for five years. Thus, the corporation would be taxed as a regular corporation for the year of termination and the next four years.

Notwithstanding these rules, Section 1.1372-5(a) of the Income Tax Regulations states that the Internal Revenue Service can consent to a new election within the five years. The consent will normally be given if the corporation can show that (1) the event causing the termination was not reasonably within the control of the corporation or its shareholders, and (2) such event was not part of a plan to terminate the election. This regulation also provides that a change in stock ownership of more than 50 percent will tend to establish that a new election should be granted by the Service.

Revenue Rulings 78-275 and 78-307 are good examples of situations where the Service waived the five-year waiting period where circumstances beyond the taxpayer's control resulted in a termination of the election. In both instances, the termination resulted from excess passive income.

At first glance, one might conclude that the regulation and rulings noted above eliminate the need for a change in the law. This is not the case, however. First, the rules require that in order to obtain the consent to a new election, the corporation must submit a private ruling request. This procedure involves additional expense in many cases, and it may be several months before the taxpayer knows whether its request is approved. Secondly, we are aware of no situation where the Service has ruled that the election continues unbroken. In other words, there is uncertainty as to whether the election remains intact for the year of termination.

Finally, we suggest that the proposed legislation contain no requirement that an electing farm corporation be located in a proclaimed disaster area in order to qualify for the exception. If such a provision were included, electing Florida corporations would have received no relief from the 1981 and 1982 freezes.

Mr. Chairman and Members of the Subcommittee, I would like to give you a first hand illustration of the situation that some of our grower members find themselves in today as a result of the 1981-82 freezes and also as a result of the increased production of grapefruit, and how their current status with their Subchapter S corporations could be jeopardized.

Many of our members, as a result of the 1981 and 1982 freezes, lost anywhere from all to 60% of their citrus production, and in many caes their farming income was less than the 20% requirement, thereby potentially jeopardizing their Subchapter S corporation through an act of God and not by their own election. Additionally, grapefruit production in Florida has increased substantially in the last few years and carryover stocks have doubled for each of the last three years. Many growers who had previously sold for cash voluntarily and/or involuntarily elected to consign and/or participate their fruit in order to hopefully enhance their cash position relative to the current crop. In other words, in many instances their fruit could not be sold for cash at any price because of over supply. When you go into a participation or consignment contract, you defer most all income for at least one year, thereby again placing our Subchapter S members in jeopardy of probably losing their Subchapter S status.

In view of our testimony and the concern of many of our members who operate within the Subchapter S corporation status, Florida Citrus Mutual respectfully requests your support and approval of amendments to H.R. 6055 eliminating the 20% passive income threshold.

Thank you for allowing Florida Citrus Mutual an opportunity to be here today to present our statement in support of changes in the proposed legislation. If you have need for any additional data or questions, we stand ready to supply same.

Chairman **Stark**. Thank you very much, gentlemen. I appreciate you taking the time to testify, and your testimony will be considered in drafting this legislation, and maybe we can accommodate some of your requests.

The next panel, Mr. Charles Bruce, counsel, Graham-White Manufacturing Co.; Frank Nemec, president of Marsea Marine Co.; Mr. James Bridges, counsel for McNeil Executive Services, Sequoia Ventures, and L. E. Wentz Co.; and James Pendergast, San Marcos Telephone Co.

I believe we have prepared statements from all of you, which will appear in the record in their entirety. I would ask that you summarize your statements in the order in which you are on the witness list.

Mr. Bruce, would you proceed?

STATEMENT OF CHARLES M. BRUCE, COUNSEL, GRAHAM-WHITE MANUFACTURING CO., SALEM, VA.

Mr. **Bruce**. My name is Charles Bruce. I am testifying on behalf of the Graham-White Manufacturing Co. of Salem, Va., one of the largest and oldest subchapter S corporations in the country. The company is a foundry and manufacturer of sophisticated equipment for the transportation industry.

The points I would like to present to the subcommittee are relatively straightforward, given the complexities of this proposed legislation.

We recommend that the legislation not be enacted this year because it contains too many ambiguities and untested concepts. Instead, it should be put over for further consideration into next year.

Alternatively, we recommend, at least for presently existing subchapter S corporations, as opposed to new S corporations that would be created after enactment of this legislation, that statutory fringe benefits presently available to subchapter S corporations and their shareholders—specifically, life and medical insurance plans—be retained in their present form. Or we would support the AICPA's approach, which would leave fringe benefits for S corporations that continue to meet the old 20-percent passive income test. In addition, certain other amendments of a technical nature should be made.

In general, we view this legislation as not helping presently existing subchapter S corporations to any great degree, but instead helping oil and gas and real estate partnerships, principally by allowing them to incorporate in order to achieve limited liability, by doing away with the passive income test which would affect their receipt of rental, interest, and royalty income, and by increasing the shareholder number from 25 to 35, which meshes with certain securities law provisions.

The presently existing subchapter S corporations and, in particular, Graham-White Manufacturing Co., would be hurt first and foremost by the proposed treatment of statutory fringe benefits. These corporations would lose their life insurance and accident and health plan benefits, as well as other benefits. At a minimum, they should be permitted to remain under the old rules.

The preservation of these fringe benefits is really the point we want to stress above all other points. We are pleased the American Bar Association agrees with this point.

Second, presently existing subchapter S corporations might also be disadvantaged by the manner in which the 20-percent passive income test is retained in certain instances, since under the wording of the bill not only would the test pertain to just S corporations that had earnings and profits accumulated prior to electing subchapter S, but apparently also to presently existing subchapter S corporations that have earnings and proifts due, for example, to the rules relating to the effects of accelerated depreciation on earnings and profits.

These rules are buried in Internal Revenue Code section 312(k) and in section 1377(d). Incidentally, last time this company approached Congress, it worked very closely with the committee in drafting 1377(d).

As noted by Mr. Alexander in his written statement and in his presentation before the committee today, most long-existing subchapter S corporations will not even know that they have an accumulated earnings and profits account caused by the working of these obscure provisions. Thus, they will hear about the lifting of the prohibition on passive income, and they will proceed to let passive income build up without being aware of these new rules. The wording of new section 1362(d)(3)(A) should be amended to solve this problem.

Third, we believe that the ordering of the distribution for earnings and profits should be clarified to avoid creating difficulties for presently existing subchapter S corporations with earnings and profits and previously taxed income accounts.

The proposed new section 1368(c) provides that a distribution in excess of the so-called accumulated adjustments account, a new term of art, will first come out of accumulated earnings and profits and be taxable as a dividend and then be treated as a gain from the sale or exchange of property.

It is difficult, in brief, to understand exactly how these provisions will work. We just want to make sure that there is not a lock-in created, and that we are not locking-in our previously taxed income.

Regarding the three specific questions raised by the subcommittee's press release, we would only comment that as to the existing 80-percent limitation on foreign income, it appears unnecessary and that it be eliminated.

I would also add that we support the amendment that would facilitate ESOP's ownership of S corporation stock. We also think that S corporations should be allowed to own a DISC—which under private letter rulings they can do today—and they also should be able to own a foreign subsidiary.

We do not begrudge any groups any of the benefits this bill might give to them. We do object, however, to those benefits being offset by sacrificing the welfare of presently existing subchapter S corporations.

Finally, we respectfully submit that these revisions are extremely complicated and cannot be characterized as simplification. In fact, the net effect of this bill may be to force many existing subchapter S corporations to convert into regular subchapter C corporations because the benefits no longer justify the complexity.

Thank you.

Chairman **Stark**. Thank you.

[The prepared statement follows:]

STATEMENT OF GRAHAM-WHITE MANUFACTURING COMPANY

Mr. Chairman,

My name is Charles Bruce. I am a member of the law firm of Cole & Corette in Washington, D. C. I am testifying on behalf of the Graham-White Manufacturing Company of Salem, Virginia, one of the largest and oldest Subchapter S corporations in the country. The company develops, manufacturers and markets sophisticated equipment principally for the trucking and railway industries. It operates what has been recognized as one of the best specialty foundries in the U.S.

The points I would like to present to the Subcommittee are relatively straightforward, given the complexities of this proposed legislation. We recommend that the legislation not be enacted this year but be put over for further consideration next year. Alternatively, we recommend, at least for presently existing Subchapter S corporations, that statutory fringe benefits available today to Subchapter S corporations and their shareholders -- specifically group life and medical insurance plans -- be retained in their present form and that certain other technical amendments be made.

In general, we view this legislation as not helping presently existing Subchapter S corporations to any great degree, but instead helping oil and gas and real estate partnerships -- principally by allowing them to incorporate in order to achieve limited liability, by doing away with the passive income test which would affect their receipt of rental, interest, and royalty income, and by increasing the shareholder number from 25 to 35, which meshes with certain threshold requirements for exemption from registration under the securities laws.

Presently existing Subchapter S corporations and, in particular, Graham-White Manufacturing Company, would be hurt by the proposed treatment of statutory fringe benefits. These corporations would lose their group term life insurance and accident and health plan benefits, as well as other benefits. At a minimum, they should be permitted to elect to remain under the old rules.

Presently existing Subchapter S corporations might also be disadvantaged by the manner in which the 20 percent passive income test is retained in certain instances, since under the wording of the bill, not only would the test pertain to S corporations that had earnings and profits accumulated prior to electing Subchapter S, but apparently also to presently existing Subchapter S corporations that have earnings and profits due, for example, to the rules in section 312(k) and its predecessors (relating to the effects of accelerated depreciation on earnings and profits accounts) and section 1377(d) (relating to the determination of earnings and profits for purposes of computing distributions of previously taxed income). Most long existing Subchapter S corporations will not even know they have an accumulated earnings and profits account caused by the workings of these obscure provisions. Thus, they will hear about the lifting of the prohibition on passive income and will proceed to let passive income built up without being aware of this trap. The wording of the proposed new section 1362(d)(3)(A) should be amended to solve this problem.

Lastly, we believe that the ordering of distributions where earnings and profits are present should be clarified to avoid creating difficulties for presently existing Subchapter S corporations with earnings and profits and previously taxed income accounts. Proposed new section 1368(c) provides that a distribution in excess of the "accumulated adjustments account" first will come out of accumulated earnings and profits and be taxable as a dividend and then will be treated, we understand, as gain from the sale or exchange of property. It is unclear how undistributed previously taxed income and earnings and profits again created by the workings of section 312(k) and its predecessors and 1377(d) would be treated under these new rules. We suggest that it be made clear that what is presently known as previously taxed income will come out tax-free and will not be "locked-in" and, in particular, will not be "locked-in" by earnings and profits created by the aforementioned sections.

Regarding the three specific questions raised in the Subcommittee's Press Release, we will only comment as to the existing 80% limitation on foreign income that it appears unnecessary and should be eliminated.

Mr. Chairman, we do not begrudge other groups any benefits which this bill might give to them. We do object, however, to those benefits being offset by sacrificing the welfare of presently existing Subchapter S corporations.

Finally, we respectfully submit that these revisions are extremely complicated and cannot be characterized as simplification. In fact, the net effect of this 66-page bill may be to force many existing Subchapter S corporations to convert into regular Subchapter C corporations because the benefits no longer justify the complexity.

Thank you for this opportunity to testify.

Chairman **Stark**. Mr. Nemec?

STATEMENT OF FRANK A. NEMEC, CHAIRMAN AND PRESIDENT, MARSEA MARINE GROUP

Mr. **Nemec**. My name is Frank Nemec. I am chairman and president of the Marsea group of companies.

I appear here today to support elimination of the 80-percent limitation on gross receipts from foreign income sources.

Presently the Marsea group operates 16 off-shore tug supply vessels in the domestic service, built at the cost of about $60 million. In addition, by the end of the year we shall have 10 more in service, making a total of 26, and making the Marsea fleet the largest single fleet of modern, medium-power supply boats under one house flag in the entire world.

Yet, at a time when the United States needs to generate badly needed foreign exchange to help improve our balance of payments, the 80-percent limitation inhibits our Nation's ability to effectively compete in certain foreign markets.

It is a little known economic miracle that at a time when our Nation's merchant marine fortunes are dropping daily to the lowest level in 100 years, that about 70 percent of the entire world's off-shore service fleet, was built in U.S. shipyards and about 60 percent of the world's entire fleet of off-shore supply vessels are registered under the American flag and owned by U.S. owners.

Yet, this leadership provision is all too fragile to destroy the momentum of American yards and owners by erecting or maintaining operational barriers, and we risk losing our lead in these markets.

Today, this very day, 50 percent of the Marsea fleet is unemployed, tied to the dock, while the world cries for tug supply boats. Yet, because of the foreign source income limitations of subchapter S, we are unable to compete effectively in most world markets.

Let me illustrate that fact by an example of a couple of our vessels today, and point out the unnecessary limitation which is present in existing law. This very day we have in service in Ecuador two vessels which are chartered to an instrumentality of the Ecuadoran Government. We are paid in the United States in dollars, and all such recepts are reported for tax purposes on returns which are filed with the Internal Revenue Service in Dallas.

Yet, because of the 80-percent limitation, we are forced to rotate vessels at an enormous cost to the corporation. We have just completed rotating one vessel so that it will not exceed the 80-percent limitation, and the round voyage cost is $35,000 each way, or a total of $70,000, posing a very substantial economic burden upon these companies.

It hardly seems to make sense to thus limit our ability to compete. Perhaps even more importantly, we can utilize this form of rotation only in limited geographical areas, and by that I mean we are unable at all to take vessels into thriving markets in the North African Continent, in the West African Continent, into the Red Sea, into the Persian Gulf, into the Indian Subcontinent to Australia, Indonesia, and elsewhere.

These are simply too far to be able to rotate these vessels so as to maintain the modicum of domestic source income and not fall out of the subchapter S qualification. It makes no sense whatsoever to keep us out of these markets at a time when the foreign competitors of ours are very envious of our position worldwide, and to deny us the opportunity to compete effectively in these very, very valuable areas.

Accordingly, we entreat you to eliminate this provision of law. It is discriminatory. There is no such provision against single proprietorships, against partnerships, or against corporations. It serves no national purpose. Indeed, all returns are auditable and the IRS has suitable weapons at its behest to handle any situation that it chooses.

Further, it disadvantages our balance of payments, and limits our markets, causing unemployment and unnecessary cost to owners. I think perhaps most importantly it endangers our Nation's worldwide position in the building and operation of supply vessels.

However, if there are any good reasons why this provision should not be eliminated from the law—and I have heard none here today, being pleased at the unanimity of all of the testimony to eliminate this provision of law, then I say to you exempt, exclude, U.S. vessels from application of these provisions as of January 1, 1982.

With that, we would be able to compete freely and effectively anywhere in the world on equal terms with our foreign competition.

Thank you, Mr. Chairman.

[The prepared statement follows:]

STATEMENT OF FRANK A. NEMEC
CHAIRMAN
MARSEA MARINE GROUP

My name is Frank A. Nemec, and I appear here today as Chairman and President of the Marsea Marine Group which consists of sixteen Tug/Supply vessels engaged in support of the offshore petroleum industry. These sixteen vessels represent an investment of approximately $75,000,000, all of which has been recycled back into the economy of the United States since all of these vessels were built in American shipyards with products of American factories and labor.

It is not generally recognized, but the development of offshore supply boats has been uniquely a function of the United States. On the Gulf Coast where offshore drilling and production began, the evolution of supply vessels was a unique and domestic trend. Over the years these vessels have evolved into sophisticated carriers tying shoreside bases into offshore drilling units whether based on mobile rigs or production platforms. The American vessels today are the state of the art, but will remain so only if sufficient orders flow into American shipyards to maintain the unique momentum which they have generated.

Over the past five years, U. S. shipyards have produced approximately two-thirds of the world production of offshore supply vessels. This is a beneficial development since all such vessels are produced without the aid of direct Government subsidy, with Government aid being limited solely to the facilitation of Title XI guarantees to those owners who have made application for same.

This marked advantage of the United States in the production of supply vessels and in the utilization of them in world markets may be lost unless unnecessary impediments to their worldwide employment are removed. One of such impediments is the provision in the Internal Revenue Code which limits Subchapter S corporations to having no more than 80% of foreign source income. The present provisions of law:

1. Discriminate against Subchapter S corporations.

   No such provisions are applicable to single proprietorships/partnerships whether limited or general or ordinary corporations.

2. Subchapter S corporations are all instruments of U. S. law and are subject to IRS regulations. Their income and experses are audited by IRS staff, and if any abuses exist they may be dealt with on a specific case by case basis.

3. It is particularly harmful to employment of U. S. flag vessels in foreign waters.

   In any such operations vessels must be rotated back into the domestic commerce so as to avoid disqualification. This unnecessarily and unfairly increases operating costs of such vessels and limits the geographical extent to which such vessels may compete in foreign markets.

To illustrate the manner in which the existing provisions unfairly limit the operation of American flag vessels let me recite the situation as it pertains to American flag offshore supply vessels built in U. S. shipyards and seeking to engage in foreign trade.

First, because of the 80% limitation on foreign source income it is necessary to rotate vessels back into domestic commerce in order to insure in the course of any year the limitation is not exceeded. This need for rotation limits the geographic area in which these offshore supply vessels can operate to the Caribbean Sea and areas proximate thereto. It simply is not feasible to dispatch vessels to Africa, to serve the offshore oil trades and rotate such vessels back into the U. S. in order to provide the necessary domestic source revenues.

This completely forecloses the more distant foreign markets to U. S. flag vessels and serves no useful purpose in doing so. These limitations further tend to adversely affect the U. S. balance of payments.

At the present time markets available to vessels owned by my companies in the Gulf of Mexico are very soft, and on Friday, June 11, 1982, nine of the sixteen vessels were tied up and all crews laid off. On the other hand, world markets are exceedingly strong and it is very likely that we could find employment for all nine of these vessels outside of the Caribbean area. Such employment sould redound to the benefit of the United States by creating employment for seamen and officers, would result in purchases of spares and supplies, and would contribute to the balance of payments. In my opinion, this forced unemployment of the Marsea Group serves no purpose and results in unfair economic and unnecessary penalties being levied on these vessels and the communities which they serve.

In a particular case, we have chartered two vessels to an instrumentality of Equadoran government, payment is received in dollars in New York and all monies are reported as income for tax purposes. Because of the limitation, however, it is necessary for us to rotate vessels in and out of Equador at an exceedingly high cost to the venture. We are currently in process of making such a rotation and the cost of a single voyage to substitute a vessel in Equador will be approximately $35,000. The return trip of the substituted vessel will represent another $35,000, thereby increasing the total cost of the rotation exercise to approximately $70,000. Later in the year, a similar futile exercise will have to be done with the second vessel employed offshore Equador in order to comply with the existing provisions of law. This increased cost is a direct penalty to the Subchapter S corporation owner/operator of these vessels and serves no National purpose.

I fail to see any reason for maintaining the 80% limitation in law. If, however, there are other reasons why such limitation should be maintained I strongly urge that the operation of U. S. flag vessels be exempted from this provision of law. Such a change is essential in order to:

(a) Remove an unfair existing discrimination

(b) Permit U. S. flag offshore supply vessels to compete in all foreign markets, and

(c) Remove a burdensome cost penalty which tends to limit the geographic scope of operations and unfairly penalizes Subchapter S corporations operating U. S. flag vessels in foreign trades.

I believe removal of this limitation is eminently fair and equitable and in the National interest, and I respectfully request this Committee to amend the Bill to eliminate this unsuitable penalty.

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Chairman **Stark**. Thank you, Mr. Nemec.

The next witness is Mr. James R. Bridges. Are you the James R. Bridges of Lafayette, Calif.?

STATEMENT OF JAMES R. BRIDGES, COUNSEL, McNEIL EXECUTIVE SERVICES CO., SEQUOIA VENTURES, INC., AND L. E. WENTZ CO.

Mr. **Bridges**. That is correct, Mr. Chairman.

Chairman **Stark**. You are making me feel very old when I think I used to play on your parents' tennis court when you were probably still in college, if not high school. Welcome to the committee.

Mr. **Bridges**. Thank you.

Chairman **Stark**. It is good to see you here.

Mr. **Bridges**. Thank you.

For the record, my name is James R. Bridges. I am a partner in the San Francisco law firm of Thelen, Marrin, Johnson & Bridges. I am appearing on behalf of a number of our clients who are interested in this bill. It seems to me that the primary purposes of the bill are to simplify the law and to make it more understandable and more easily accessible.

We have heard a lot today about accumulated earnings. In my view, the accumulated earnings provisions of this bill are short and simple and should be easily understood. In fact, they continue, basically, provisions which have been in the law for 25 years. For that period of time, regular corporations with accumulated earnings have been permitted to make a subchapter S election without paying a toll charge.

Now it is suggested that there is a perceived reason why such corporations having accumulated earnings ought to pay a toll charge, or at least ought to have the option of paying a toll charge, thus creating a two-track system, one for those who choose to purge their accumulated earnings, or who never had it, and one for those who do not purge their accumulated earnings.

You have heard a lot of testimony today about the complexity that this would add to the bill. The toll charge proposals themselves would add a great deal of complexity. In addition, you have also heard of the bailout possibilities that the toll charge proposal would cause, bailout possibilities, not only in terms of taking out accumulated earnings at capital gains rates but also in terms of distributing appreciated property with no tax at all.

Quite clearly, the imposition of the toll charge proposal would cause enormous additional complexity in the bill. If Congress nonetheless chooses to adopt the toll charge approach, it seems to me that it ought to be quite careful that, in doing so, it makes the approach truly elective. By that I mean it should not cause the second track, the track for corporations with accumulated earnings, to be so onerous that, de facto, it forces all corporations who would elect subchapter S to purge themselves of their accumulated earnings.

I would like to give you an example from the real world. We talk about these kinds of things. One of the clients I represent is a small construction company, with a sole shareholder. He has had the good fortune, despite the recent state of the economy, of doing quite well. He has made a great deal of money. He has a significant amount of accumulated earnings, all of which are dedicated to his business.

If he chooses to go subchapter S, which for other reasons would be quite attractive to him, he would be faced with a dilemma. Either he purges himself of accumulated earnings, which in his case would in effect mean a partial liquidation of his business, because his earnings are not represnted by cash but by assets, or he is back in the ball game of worrying about the passive income test.

We have also heard a lot about that passive income test. The staff of the joint committee recommended that the test be deleted in its entirety in their 1980 report, and they did so because they concluded that the test promotes litigation, and results in inadvertent terminations, that it is in fact a trap for the unwary.

In the case of the gentleman I am discussing, let's assume that he is on the completed contract method. He doesn't know which of his contracts are going to be completed in any given year. He cannot adjust the mix of his gross receipts to insure that he doesn't run afoul of the test, so he has a true dilemma, and in fact you really are forcing him, if he wants to make the subchapter S election, to purge accumulated earnings.

You are forcing a partial liquidation. So if you are going to adopt the toll charge, I suggest that it should be made truly elective. Do not impose a penalty on those who elect not to purge accumulated earnings. Instead, withhold benefits.

With regard to the passive income test, it seems to me that the only reason put forth today for the retention of the test for corporations with accumulated earnings has to do with a perceived tax shelter, which, on analysis, quite clearly has to do with section 1014 and stepped up basis rules on death.

Whatever the merits of the arguments regarding carryover versus stepped up basis on death, it hardly seems appropriate to single out the shareholders of a subchapter S corporation for a denial of a benefit available to the shareholders of all other corporations.

Last, I would like to say a brief word about the eligible shareholders of a subchapter S corporation. Under present law and the bill, grantor trusts are eligible shareholders. Qualified subchapter S trusts are treated as grantor trusts, and thus are also eligible shareholders. There is, however, an anomaly in the definition of qualified subchapter S trusts.

Under the bill, a qualified subchapter S trust would be required to distribute all income currently. This would effectively exclude accumulation trusts from treatment as subchapter S trusts.

On the other hand, it is also quite clear that grantor accumulation trusts are permitted shareholders. It seems to me that there is no reason at all for this distinction between grantor trusts and qualified subchapter S trusts. One of the purposes of the bill is to broaden access to subchapter S. I would suggest that removing the income distribution requirements from the definition of a qualified subchapter S trust would further that purpose.

In closing, I would like to say I believe the bill is an excellent piece of work, and that its draftsmen deserve compliments. I do think it falls short in a couple of areas. I believe the passive income test should be deleted in its entirety. It is an anachronism. It should not be retained even in part, and accumulation trust should be permitted to fall within the definition of qualified subchapter S trusts.

Thank you.

Chairman STARK. Thank you very much.

[The prepared statement follows:]

STATEMENT OF JAMES R BRIDGES

The proposed Subchapter S Revision Act of 1982 (H.R. 6055/S. 2350) (the "Bill") represents a welcome attempt to simplify subchapter S, remove traps for the unwary as well as unintended tax avoidance opportunities which exist under present law, and broaden access to subchapter S. The Bill is extremely well thought out and well drafted and, in general, succeeds admirably in achieving its purposes. The sponsors of the Bill have invited public discussion, in particular with respect to (i) the appropriate treatment of regular corporations ("C corporations") electing subchapter S status, (ii) the retention of the passive income limitation of present law, (iii) the one class of stock limitation, and (iv) retention of the foreign income limitation of present law. This paper comments on the first two of these issues as well as an additional aspect of the Bill.

I. SUMMARY OF COMMENTS

A. The Bill would continue present law in permitting all C corporations, including those with as well as those without accumulated earnings and profits, to make the subchapter S election without the imposition of a penalty or charge incident to the election. No tax avoidance opportunity would be afforded thereby. The imposition of such a penalty or charge would significantly restrict access to subchapter S and complicate its provisions, thus defeating basic objectives of the Bill.

B. Similarly, the passive income limitation of present law should be deleted in its entirety, not retained with respect to S corporations with accumulated earnings and profits as the Bill proposes. Total elimination of the passive income limitation would not create a tax avoidance possibility. Partial retention of the limitation would restrict access to subchapter S and perpetuate the confusion and trap for the unwary inherent in present law, again defeating basic objectives of the Bill.

C. The definition of qualified subchapter S trust should be expanded to include accumulation trusts. Grantor and similar accumulation trusts are permitted to be shareholders of S corporations under present law. Expansion of the definition of qualified subchapter S trusts to include accumulation trusts would be consistent with the treatment of grantor and similar trusts, would violate no policy, and would further the Bill's objective of broadening access to subchapter S.

II. DETAILED DISCUSSION.

A. Treatment of C Corporations Electing S Corporation Status.

Under present law, the subchapter S election is equally available, without penalty or charge, to all corporations -- newly formed corporations, existing C corporations without accumulated earnings and profits ("AEP") and existing C corporations with AEP. The Bill would not change this treatment.

The sponsors' floor statements made when the Bill was introduced pointed out that under existing law: (i) the shareholders of a C corporation with AEP are subject to tax when AEP is distributed, whether as a dividend or in liquidation; (ii) this result follows even though the liquidation is in order to continue the business in partnership form; and (iii) AEP accumulated beyond the reasonable needs of a C corporation's business in order to avoid tax on the shareholders is subject to a penalty tax. The sponsors went on to say that if the many favorable partnership-like rules in the Bill are adopted, it might be necessary, in effect, to treat a C corporation converting to S status as if it had liquidated and converted to a partnership.

The §531[*] penalty tax on unreasonable accumulations of AEP by a C corporation is irrelevant to the discussion of the proper treatment of a C corporation converting to an S corporation. The §531 tax applies only to the incremental unreasonable accumulations of the current year; past years' unreasonable accumulations are not again subjected to the tax. Once a C corporation converts to S status the §531 tax cannot apply since, by definition, any accumulations cannot be for the purpose of avoiding tax to the shareholders.

The shareholders of a C corporation are taxed on its liquidation for the very good reason that, as a result, they have the assets of the corporation, including its AEP, at their immediate disposal. This is so whether they retain those assets, sell them, contribute them to a partnership, or otherwise dispose of them. The same tax treatment would be appropriate for a C corporation with AEP converting to S status if, by reason of that conversion, the AEP could be distributed to the shareholders tax-free. In fact, of course, under present law distributions by an S corporation from AEP are taxable dividends and the normal rules apply to the liquidation of an S corporation. Since the Bill would retain both concepts, there are no favorable partnership-like rules in the Bill which make it appropriate, much less necessary, to levy a current tax on the conversion of a C corporation to an S corporation.

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[*] All references herein are to sections of the Internal Revenue Code of 1954, as amended, unless specifically indicated to the contrary.

The sponsors' implicitly recognized this when they went on to say that if it were not for the need to retain taxable dividend treatment for distributions out of AEP, it might be possible to treat distributions of property (as opposed to cash) as tax-free carryover basis transactions similar to the treatment accorded partnership property distributions. Under present law, distributions of property by an S corporation are taxed as dividends to the extent of AEP. Under the Bill, distributions of appreciated property would cause the S corporation to recognize gain to the extent of the appreciation.

In its essentials, the argument would appear to be that if there were no need to deal with AEP and taxable dividends the Bill could be more beneficial to small businesses. In practice, it would seem unlikely that an S corporation would be interested in distributing appreciated property in circumstances in which recognition of gain on the distribution would be inappropriate. If the shareholders of the S corporation intended to dispose of the property in a taxable transaction, recognition of gain on the distribution would not be a hardship. If, instead, they intended to hold the property in prorata shares, they could continue to do so through the S corporation without recognition of gain. In fact, whether or not carryover basis treatment for property distributions would be of any significant practical benefit to S corporations, the argument that it is the possible existence of AEP which prevents such treatment is invalid. As the sponsors indicated, the Bill for the most part is based on the recommendations of the staff of the Joint Committee on Taxation published on April 30, 1980 (the "Staff Report"). The Staff Report considered and rejected substituting the partnership carryover basis rule for the fair market value rule:

> "The choice of the partnership adjusted basis rule for distributions would have necessitated the adoption of the partnership collapsible rules (see section 751(b)). Staff found these collapsible rules to be unworkable in many instances. Moreover, any unfavorable consequences of the partnership adjusted basis and

> corresponding collapsible rules could be avoided by simply revoking the subchapter S election and, thereby, obtaining the benefits of the subchapter C fair market value distribution rules.
>
> Consequently, the fair market value rule of present law was retained to avoid both the complexity of the partnership collapsible rules and the tax gamesmanship resulting from what would in effect be a choice between the Subchapter S adjusted basis rules and (by revocation of the election) the subchapter C fair market value rules." [Staff Report, part III, section H.1.]

Thus, the objections to carryover basis had nothing to do with AEP or the need to preserve taxable dividend treatment for distributions from AEP. Rather, staff was of the view that the choice of carryover basis would be complicating, not simplifying, and would lead to tax abuse. Tax abuse possibilities would be multiplied if, as some proponents of the toll charge have proposed, the toll charge were to be coupled with elimination of the §531 tax as applied to a C corporation in the 3 years preceding its conversion to an S corporation. The inclusion of provisions to eliminate these tax abuse possibilities would heap complexity upon complexity.

In short, there is no policy reason to prevent a C corporation with AEP from converting to an S corporation or to impose a toll charge on such conversion. To do either would simply defeat a primary purpose of the Bill

-- to broaden access to subchapter S. Further, either approach would create an additional trap for the unwary. It is well understood that most small businesses are not the beneficiaries of sophisticated tax advice. AEP calculations many times are complex and difficult. This is true now more than ever since the amendment to §312(k) made by the Economic Recovery Tax Act of 1981 ("ERTA") regarding the adjustment to earnings and profits to reflect depreciation with respect to §168 recovery property and §179 property. A C corporation with no earned surplus might well conclude that it also had no AEP and thus could safely convert to an S corporation only to discover at some later date that the conversion either was ineffective or subjected it or its shareholders to a toll charge. Lastly, any toll charge which subjected the shareholders to tax as if the corporation's AEP had been distributed as a dividend would be excessively onerous and, presumably, would be rejected for that reason. On the other hand, taxing AEP as capital gain upon a subchapter S election would permit use of a temporary subchapter S election for bailout purposes, in turn requiring safeguards which would compound the complexity.

The provisions of the Bill regarding taxable dividend treatment for distributions from AEP and adjustments to AEP are short and simple and, in essence, merely continue familiar rules of present law. On the other hand, the imposition of a toll charge on C corporations with AEP converting to S status would require the erection of an entirely new, unfamiliar and vastly complicated superstructure of rules and a panoply of provisions to protect against abuse of those new rules. Thus, such a toll charge, in addition to being unnecessary, would defeat the Bill's objective of simplification.

The Bill makes subchapter S available to all qualified C corporations, those with AEP as well as those without. In so doing, the Bill continues the policy which has been in place since subchapter S was enacted in 1958. No changes in the Bill in this regard are either necessary or appropriate.

B. The Passive Income Limitation.

Under present law, an S corporation loses S status if in any year more than 20% of its gross receipts are "passive income" -- dividends, interest, rents, royalties, annuities and gains from sales or exchanges of stock or securities. The Bill would retain the passive income test for S corporations with AEP and delete it for all other S corporations.

The principal reason for the inclusion of the passive income test in subchapter S as originally enacted in 1958 appears to have been a concern that individuals would "incorporate their pocketbooks" in order to obtain the tax deferral benefits accorded qualified pension and profit-sharing plans. Staff Report, part III, section A.5. This concern has been of little validity since the passage of the Tax Reform Act of 1969, and would disappear totally with the adoption of the deferred compensation provisions of the Bill. Further, the deletion of the passive income test is entirely consistent with the purposes of the personal holding company rules -- the shareholders of an S corporation are taxed currently on the investment income of an S corporation. Staff Report, part III, section A.5. The Bill implicitly recognizes all of this in its deletion of the passive income test for S corporations without AEP.

In recommending total elimination of the passive income test the Staff Report stated:

> "[The] passive income limitation has caused a number of inadvertent terminations of elections, as well as a substantial amount of litigation as to what constitutes passive investment income. Controversy exists as to whether the term passive investment income includes interest and rents which are earned in the active conduct of a trade or business (e.g., interest of a small loan company or produced film rents of an active production company). Elimination of this restriction would remove much uncertainty, reduce litigation, and prevent retroactive terminations of subchapter S elections." [Staff Report, part III, section A.5.]

Partial retention of the test, as proposed in the Bill, would perpetuate the confusion and complication described in the Staff Report. A C corporation which wished to make the subchapter S election and which had significant AEP would be faced with a dilemma -- whether to effect, in substance, a partial liquidation, thus eliminating AEP, or to run the risk of a subsequent inadvertent termination of S status because of an inability to control the exact mix of its gross receipts or to know with certainty whether each item of those receipts was active or passive for purposes of the test. Moreover, as mentioned earlier, AEP calculations are often complex and difficult. A C corporation with no earned surplus, which therefore concluded that it had no AEP and could safely convert to a S corporation, might well find out later that in fact it had AEP and was subject to the test. Thus, partial retention of the passive income test would perpetuate a trap for the unwary.

Given the foregoing, there would have to be a strong policy reason to justify the retention of the passive income test for S corporations with AEP. Is there any such reason? The sponsors stated that the partial retention of the test was necessary in order to prevent avoidance of shareholder tax on AEP. The scenario they presented was as follows: a C corporation whose shareholders hold low-basis stock sells its operating assets; no capital gains tax is levied at the shareholder level; the corporation invests the proceeds of the sale (which represent AEP) in passive investments; the corporation makes a subchapter S election; the shareholders, on death, obtain a stepped-up basis.

Apparently there are those who believe this scenario represents a tax planning technique which could easily be used to forever shelter AEP from taxation at individual rates and that the use of a subchapter S election would be critical to the success of the scheme.

A comparison of the tax results of such a series of events between, on the one hand, a C corporation not making a subchapter S election and, on the other, a C corporation making a subchapter S election (and not, thereafter, being subject to the passive income test), is in order. First, since the sale occurs when both corporations are C corporations, the tax consequences of the sale -- tax on the gain at the corporate level -- are exactly the same in both cases. If either corporation retains earnings and profits beyond the reasonable needs of its business in the year of sale in order to avoid tax on its shareholders, it will be subject to the penalty tax imposed by §531. Following the sale, any dividends by either corporation out of AEP at any time will be fully taxed at the shareholder level. If a shareholder of either corporation dies before AEP is distributed, his shares will be included in his taxable estate at their fair market value, which presumably will reflect AEP, and will obtain a stepped-up basis. Subsequent dividends out of AEP by either corporation will be fully taxed to the deceased shareholder's estate or heirs. If the estate or heirs of a deceased shareholder of either corporation sells the shares or the corporation liquidates before the AEP is dividended, the estate or heirs, by reason of the stepped-up basis, will avoid tax on the AEP.

Where, in any of this, is there any difference in the tax treatment of the electing corporation and its shareholders from that of the non-electing corporation and its shareholders? As regards AEP, no such difference exists. No unique ability to "forever shelter" AEP from tax at individual rates would be created if the passive income test were deleted in its entirety.

This is not to say that no difference at all would exist between the tax treatment of the non-electing C corporation and the electing S corporation in the scenario discussed. The passive investment income of the C corporation would be taxed at the corporate level and again, if and when distributed, at the shareholder level. The passive investment income of the S corporation would be taxed once, to the shareholders. The latter, of course, is exactly the manner in which the passive investment income of an S corporation without AEP would be taxed under the Bill. This difference, then, follows from the basic concept of subchapter S and has nothing to do with AEP. To find this difference unacceptable would be to exalt double taxation as a policy objective, and the elimination of subchapter S, rather than its simplification and expanded availability, would be in order.

There being no tax avoidance opportunity attendant upon the complete elimination of the passive income test, why then do the proponents of partial retention of the test wish to deny the benefits of the stepped-up basis rules to the shareholders of S corporations with AEP when those rules would be available to the shareholders of all other corporations (and to all partners in partnerships and all sole proprietors)? Clearly the proponents of partial retention of the test find the stepped-up basis rules objectionable in general. It is the tax avoidance possibilities they perceive to be inherent in the stepped-up basis rules to which they object, not to any peculiar result which would follow from the application of those rules to S corporations with AEP.

The debate between the proponents of carryover basis and those of stepped-up basis has raged for many years and, no doubt, will go on for many more. It is not necessary to argue the merits of either side of the case here. It is sufficient to note that there is no reason to single out the shareholders of an S corporation with AEP for a penalty to which taxpayers in general are not subject. Those shareholders should not be claimed as the innocent victims of a war which has nothing to do with them. If yet another campaign is to be mounted against stepped-up basis, let it be a frontal assault which can be seen for what it is, not a sneak attack.

The Staff Report is correct. The passive income test serves no useful purpose. Elimination of the test in its entirety will not promote tax avoidance and will both simplify and broaden access to subchapter S as well as removing a trap for the unwary, thus furthering basic objectives of the Bill.

C. The Definition of Qualified Subchapter S Trusts.

Present law (§1371(g)(3)) defines a qualified subchapter S trust (a "qualified S trust") as a trust,

(A) which owns stock in one or more S corporations,

(B) all of the income of which is distributed currently to one individual who is a citizen or resident of the U.S., and

(C) the terms of which require that -

(i) at any time, there shall be only one income beneficiary of the trust,

(ii) any corpus distributed during the term of the trust may be distributed only to the current income beneficiary thereof,

(iii) each income interest in the trust shall terminate on the earlier of the death of the income beneficiary or the termination of the trust, and

(iv) upon the termination of the trust during the life of an income beneficiary, the trust shall distribute all its assets to such income beneficiary.

The Bill provides a helpful clarification of the meaning of "income" as used in (B) above and expands (B) to include trusts whose income is required to be distributed currently as well as those whose income actually is distributed currently. Bill §1361(d)(3).* In other respects it would seem the Bill intends to retain the present definition of a qualified S trust. The reference is to the "apparent intention" of the Bill for two reasons. First, in (B) the Bill refers only to "a citizen" rather than to "a citizen or resident of the U.S." Bill §1361(d)(3)(B). This seems clearly inadvertent since the Bill retains the provisions of present law permitting resident aliens to be shareholders of S corporations either directly or through a grantor or similar trust. This misreference in the Bill obviously must be corrected. Second, the Bill uses the word "or" at the end of (B) rather than the word "and." Bill §1361(d)(3)(B). Again, this seems inadvertent. Otherwise the words "and either" would follow Bill §1361(d)(3)(A).

A basic purpose of the Bill is to remove unnecessary eligibility restrictions and broaden access to S corporation status. In part, the Bill achieves this by increasing the number of permitted shareholders from 25 to 35. Expanding the definition of qualified S trusts to include accumulation trusts obviously would further this objective of the Bill.

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* References to Bill sections are to sections of subchapter S of the Code as it would be amended by the Bill.

The proposal to expand the definition is simple and straightforward. The Bill should define a qualified S trust as one which (i) holds stock in one or more S corporations, and (ii) meets the requirements of Bill §1361(d)(3)(C). Those requirements would be expanded to include the condition that the income beneficiary be a citizen or resident of the U.S. The income distribution requirements of Bill §1361(d)(3)(B) are unnecessarily restrictive and should be deleted.

Any objection to this proposal should be based on the policy underlying the inclusion of the income distribution requirements of (B) in the definition of a qualified S trust as originally enacted as a part of ERTA. That policy is not readily apparent. Prior to ERTA, with limited exceptions, the only trusts permitted as shareholders of an S corporation were grantor trusts. ERTA expanded the category of permitted trusts to include (i) trusts all of which are treated as owned by grantors or others under §§671 et seq. and (ii) qualified S trusts. ERTA viewed qualified S trusts as no different, in essence, from grantor and similar trusts. Rather than establishing qualified S trusts as an entirely separate category of permitted shareholders, ERTA provided that such trusts would be treated as trusts described in

§1371(c)(1)(A) -- i.e., as if they were grantor or similar trusts. §1371(g)(1)(A). The Bill retains this treatment. Bill §1361(d)(1)(A). Further, under both ERTA (§1371(g)(1)(B)) and the Bill (Bill §1361(d)(1)(B)), the income beneficiary of a qualified S trust is treated as the owner (for purposes of §678(a)) of that portion of the trust which consists of stock of the relevant S corporation.

Accordingly, it is appropriate to ask whether there is anything in the definition of a grantor trust similar to the income distribution requirements of Bill §1361(d)(1)(B) with respect to qualified S trusts. There is not. The definition of a trust all or any portion of which is treated as owned by a grantor or other person under §§671 *et seq.* has nothing to do with the actual or required current distribution of income. Quite clearly, accumulation trusts can be treated as grantor or similar trusts under the rules of those sections and, thus, can be permitted shareholders of an S corporation.

The key to inclusion of grantor and similar trusts as permitted shareholders of an S corporation is that all of the income of such a trust derived from or attributable to stock of an S corporation is taxed to a single individual whether or not that income is or is required to be distributed currently. Thus, such trusts cannot be utilized to spread such income among multiple taxpayers, thereby reducing the overall effective rate of tax on the income and complicating accounting and auditing procedures. Exactly the same purpose is served by the requirements of Bill §1361(d)(3)(C) in the definition of a qualified S trust, in combination with the election requirements of Bill §1361(d)(2).

In the circumstances, no policy reason is served by including income distribution requirements in the definition of a qualified S trust. Instead, those requirements operate simply to unnecessarily restrict access to the subchapter S election and, thus, to defeat a basic purpose of the Bill. Bill §1361(d)(3)(B) should be deleted.

Chairman **Stark**. Mr. Pendergast.

STATEMENT OF JAMES J. PENDERGAST, JR., PRESIDENT, SAN MARCOS TELEPHONE CO., INC., SAN MARCOS, TEX.

Mr. **Pendergast**. Yes, Mr. Chairman. I realize being last I have to be good.

Chairman **Stark**. We save the best for last always.

Mr. **Pendergast**. My name is Jim Pendergast. I am testifying on behalf of the San Marcos Telephone Co. We would support this bill because it does provide simplification and also because we believe it does make subchapter S more accessible. I will, however, confine my remarks to one area where the bill is silent rather than to any areas that the bill speaks to.

I will also confine my remarks to how subchapter S in this particular bill impacts small utility companies in this country. I would also point out that it is my feeling that if this bill remains silent to this issue I will mention today, it will further confuse rather than simplify. It will also deprive utility companies, small utility companies, of access to the subchapter S option.

By way of background, I would point out that we are an independent telephone company that provides local and toll service, perhaps the only company here today that is not opposed to any toll charge provisions in the bill for that reason.

We are one of 1,500 independent telephone companies that are not owned by the Bell System. We serve approximately 20 percent of the population of this country and 52 percent of the land mass of this country. We are, like most utilities, regulated both at the State level and the Federal level.

I think it is important to understand the regulatory process to understand how subchapter S, as stated in this bill, will impact us. I would like to give a very simple explanation, if I can.

First of all, by law, regulatory bodies must give utilities rates sufficient to return to them through a two-part formula, expenses plus a return on investment. Therefore, if, for example, the utility had $50 in depreciation expense, $50 in labor expense, and $50 in Federal income tax expense plus $100 of investment, that would earn a 10-percent return, that company would be entitled to charge $160 in rates annually to its customers.

The problem arises in the first step to that formula, as public utility commissions, do not uniformly, apply the definition of expense. When it comes to a regular corporation, they see Federal income tax expense paid by the corporation with a corporate check as an expense that is recoverable from ratepayers.

On the other hand, they are not certain how to treat a subchapter S corporation. They see it as neither fish nor fowl. It is neither partnership nor a corporation for tax purposes, and oftentimes they will refuse to reimburse Federal income taxes to that company, and what this does is it actually takes benefits that were designed for companies and its shareholders and passes them on to consumers.

My point—and I do not think this is done maliciously; I think it is done in good faith—there is really no guidance for regulators to take a look at. My point is that this bill is really silent to that matter, and if Congress really intends that the benefits of subchapter S status should be retained by the corporation and its shareholders, then it needs to be so stated. If, on the other hand, it really intends that those benefits can be flowed on to consumers, it needs to come out and say that. It will avoid confusion. I think it would, as we would propose later on in my testimony, provide a fair treatment and preserve congressional intent.

This is not a novel suggestion. I think especially being from California, you will recognize this issue. When it comes to investment tax credit on equipment that is purchased by a utility, Congress has come out and said that investment tax credit will be retained by the corporation, it cannot be flowed through to consumers.

I would suggest in this particular bill that some language be contained that would preserve the benefits of subchapter S for the subchapter S corporations rather than have it flow through. This can be accomplished in one of two ways.

I think, very simply stated, it can be said that if the corporation is liable in the event shareholders do not pay their taxes, this would again preserve those expenses as part of the ratemaking process. If an option can be built in for utility companies, I mean small utility companies, whereby these companies can elect to pay taxes on subchapter S income at corporate rates, thereby making it a corporate tax, and corporate expense, and have these taxes credited to the individuals when they come to pay their individual tax, it will accomplish the same purpose.

Our suggestions certainly can be expanded upon, and certainly can be refined, but I believe they will reduce confusion, preserve congressional intent, not increase any cost to consumers, and not decrease any taxes flowing to the Treasury.

That concludes my testimony. Thank you.

[The prepared statement follows:]

STATEMENT OF JAMES J. PENDERGAST, JR., PRESIDENT, SAN MARCOS TELEPHONE CO., INC.

My name is Jim Pendergast. I am President of the San Marcos Telephone Company, Inc. My business address is 200 South Guadalupe, San Marcos, Texas. I graduated from Canisius College, Buffalo. New York with a Bachelor of Science degree in Accounting and the University of Tulsa School of Law in Tulsa, Oklahoma with a Juris Doctorate. I have been employed by the San Marcos Telephone Company, Inc., since June, 1975, as Vice-President and General Counsel and was named President of the company on January 1, 1982. I am a member of the Board of the Texas Telephone Association and the Texas State Board of Public Accountancy.

I am appearing on behalf of the San Marcos Telephone Company, Inc., in my capacity as President.

The San Marcos Telephone Company, Inc., is a family owned, closely-held corporation, organized and existing under the laws of the State of Texas. The telephone company was purchased by H. Y. Price, Jr. in 1948, and has remained in the Price family until the present day. In March of this year the shareholders elected to have the corporation treated under Subchapter S of the Internal Revenue Code for the calendar year 1982, and following.

The San Marcos telephone Company is not affiliated with the Bell System. It is one of 1500 nation-wide independent telephone companies that provide local and long distance service to 20 percent of the telephone users in the country and 52 percent of the country's land mass.

The company serves a 172 square mile franchised area in and around the City of San Marcos, Texas, having a population of approximately 40,000. The serving area is located in Central Texas equidistant between the cities of Austin and San Antonio. We have approximately 12,000 subscribers including Southwest Texas State University with a student population in excess of 16,000 as well as Camp Gary Air

Force Base that is now used for vocational training sponsored by the Texas Educational Foundation.

AREA OF CONCERN

The purpose of my testimony is twofold. First, I will explain how the present, as well as the proposed, Subchapter S Acts deny many telephone, water and electric companies the benefits that Congress intended to flow to them under Subchapter S legislation. Second, I will suggest language that can be added to HR 6055 to preserve the benefits of Subchapter S status for small, closely-held regulated utilities throughout the country. I am willing to work with appropriate staff members to develop appropriate wording that will accomplish the goals suggested in this testimony.

BACKGROUND

All 50 states have created public utility or public service commissions for the purpose of regulating telephone, water, gas, electric, sewer and other utility companies providing service to citizens of their respective states. the state commissions, among other things, set rates that these companies charge their customers.

In accordance with the enabling statutes and a long line of case history, utilities are entitled to charge those rates that would be sufficient first, to recover the expenses they incur in providing utility service, and second, to produce a fair return on their investment.

For example, a utility having $50 in labor expense, $50 in depreciation expense and $50 in income tax expense would be entitled to charge rates designed to recover $150 on an annual basis. Further, if the shareholders invested $100 in the enterprise they would also be entitled to recover a fair return on that investment. Assuming a fair return of 10 percent, a utility would by law be entitled to charge rates designed to recover not only the $150 in expense, but also $10 in return on investment ($100 investment that would earn a 10 percent return).

My concern arises, not in the formula, but in the interpretation of what items will be classed as an expense and become recoverable from a utility company's customers in the form of utility rates.

State public utility commissions have determined that federal income tax paid by a "C" corporation on the corporation's taxable income is an expense that utilities may recover through the rates they charge their customers. Conversely, they have also determined that federal income taxes paid by shareholders of an "S" corporation on the same corporate taxable income is not an expense that may be recovered by a utility through the rates they charge their customers.

For example, a "C" Corporation that earns $100 in corporate taxable income and has $46 in corporate federal income tax is allowed to recover $46 in income tax through the rates they charge their customers.

On the other hand, an "S" corporation that has $100 in corporate taxable income on which the the shareholders pay $50 in federal income tax, regardless of whether the corporation makes a distribution for that purpose or not, is not allowed to recover the $50 income tax paid on "S" corporation taxable income through the rates they charge their customers.

State commissions refuse to recognize tax paid by "S" corporation shareholders as a cost of service but recognize taxes paid by a "C" corporation on the very same taxable income.

For this reason utilities are denied all benefits from Subchapter S status. State public utility commissions in effect flow any benefits shareholders derive from avoiding double taxation through Subchapter S status to benefit the utility's customers. No benefits accrue to the utility company's shareholders or the utility company itself.

Simply stated—if state utility commissions take Subchapter S benefits away from utilities there is no reason for them to elect "S" corporation status.

It is my understanding that Subchapter S status is a mechanism designed to remove the burden of double taxation from small, closely-held corporations and further to encourage capital formation. Our country's water companies and many of its telephone companies that serve rural areas are closely-held corporations which because of their utility nature are capital intensive. Companies that would benefit most from Subchapter S status are in fact denied the benefit through state regulatory actions.

SUGGESTED AMENDMENTS

The following amendments to H.R. 6055 are suggested

Amendment No. 1: Shareholders of Subchapter S corporations may elect to have the corporation be liable for and pay tax on "S" corporation taxable income at "C" corporation rates. Under this election, the tax paid by the "S" corporation at "C" corporation rates would be credited pro rata to each shareholder's individual income tax return, or

Amendment No. 2: Taxes paid by shareholders under Subchapter S of the Internal Revenue Code represent corporate taxes on corporate taxable income paid at applicable shareholder proxy rates, and

Amendment No. 3: The "S" corporation shall be primarily liable for payment of taxes on "S" corporation taxable income.

CONCLUSION

I believe that the requested amendments or variations of these amendments would preserve the benefits Congress intended in formulating its Subchapter S policies. No harm would flow to the federal treasury or consumers under any or all of these suggested amendments. Congressional intent would not be undermined by state regulation.

Thank you for your courtesy in allowing me to present suggested amendments to H.R. 6055 as well as the rationale for these amendments. This matter is of great importance to our company and small utility companies throughout this country. Please give these suggestions your consideration. This concludes by testimony.

Chairman **Stark**. Thank you, Mr. Pendergast. I can't resist asking this question. You may be the first utility person to answer this correctly: Would you endorse the Stark proposal which suggests that because utilities are the only true economic entity which passes its income tax directly to the consumer—other corporations can run for a while at a loss and actually thereby not pass their taxes through—but since utilities have to by law, why then, should we not? We get very little taxes out of utilities as a matter of fact; the net taxes that they pay in this country are very small. So we could probably put one-half or less than 1 percent of an excise tax on utility gross receipts, and eliminate Federal income tax on utilities.

Why wouldn't that be preferable?

Mr. **Pendergast**. Let me make sure I understand the proposal.

Chairman **Stark**. No corporate income tax.

Mr. **Pendergast**. No corporate income tax.

Chairman **Stark**. Some small gross receipts tax on utilities.

Mr. **Pendergast**. Mr. Chairman, I don't think we would oppose that, and let me tell you why. Basically, again, utilities—it is a trade off. Because they are a monopoly they can only make so much money and they are regulated. They are entitled to earn a fair return on their investment, and you can look at that return either before taxes or after taxes, and that really is the critical issue.

If you look at it after taxes, then you are entitled to recover those taxes in the ratemaking process. If you look at it before taxes, then you are entitled to a higher rate of return.

Chairman **Stark**. I don't know the answer to your problem. It may be more in how your public utility commissioner treats your taxes. They might just normalize as they certainly do in many States, where the utilities really don't pay the tax. It is particularly more true with the gas and electric utilities. But they get credit as if they were being taxed at the full corporate rate, and without any regard to what they actually pay.

They are able to pass that on to the consumer. I have objected to that a lot, but that is what happens. I don't know what the case is in Texas.

Mr. PENDERGAST. I can give you an example. For example, the Bell System, because they are a corporation, the corporation actually signs the tax check rather than the individuals, they are entitled to charge rates to cover those taxes.

Chairman STARK. They base it on the actual taxes paid or on the taxes as calculated before investment tax credit?

Mr. PENDERGAST. They base it as actually calculated rather than paid. It would be a 46-percent rate, normalizing the investment tax credit and passing it back to the consumers. My point here is that we don't even have the safeguard that they have in the investment tax credit statutes, where that benefit is preserved and maybe some benefits flow down to the consumers. If that mechanism was proper for investment tax credit purposes, it seems like it ought to be proper also for subchapter S purposes.

Chairman STARK. Thank you.

You have all presented some interesting points that I am sure the committee and staff will take under advisement as we try and come to some kind of agreement on this legislation, and I would expect that several of you will, as I said earlier, be receiving written questions from us, and we will keep the record open to allow your responses to be included in that regard. I appreciate your taking the time and effort to testify today.

That completes this morning's hearings, and the committee will resume at 1:30.

[Whereupon, at 12:20 p.m., the hearing was adjourned.]

[The following material was submitted for the record:]

AMERICAN WOMAN'S SOCIETY OF
CERTIFIED PUBLIC ACCOUNTANTS,
Chicago, Ill.

Re H.R. 6055

Mr. JOHN J. SALMON,
Chief Counsel, Committee on Ways and Means,
House of Representatives, Washington, D.C.

DEAR MR. SALMON: The American Woman's Society of Certified Public Accountants has studied this bill proposing changes in the Internal Revenue Code dealing with Subchapter S Corporations and we are pleased to submit our comments. The views expressed herein represent those of interested members of our Society.

Overall, the American Woman's Society of Certified Public Accountants does not support H.R. 6055, the Subchapter S Revision Act of 1982. This is primarily because we see no need for a complete rewriting of Subchapter S. However, one member favors several of the provisions and if such rewriting is inevitable, we herewith offer for your consideration our views on specific provisions of the bill as well as our comments on three issues not originally addressed, namely (1) how to treat regular corporations that elect Subchapter S with regard to immediate taxation; (2) the advisability of continuing the present Subchapter S limit of one class of stock in light of the fact that, under the debt-equity regulations now scheduled to take effect some time after January 1, 1983, some debt instruments could be reclassified as stock; and (3) whether the availability of the Subchapter S election should be extended to corporations deriving more than 80% of their gross receipts from foreign sources.

There are numerous reasons why we oppose the rewriting of Subchapter S; but the main one is that, as usual in the recent history of federal tax legislation, the intent is to clarify and the effect is complication. Even the terminology change from "small business corporation" to "Subchapter S Corporation" seems more obfuscation than simplification.

Any time that laws are rewritten, new problems of interpretation complicate their implementation. Since the exist Subchapter S Code Sections are clearly written and easily understood, there is no reason to rewrite those sections except, perhaps, to make minimal substantive changes. Owners are usually not knowledgeable in tax law and have their hands full merely operating the business without continually looking forward and back in an effort to be in compliance with an extremely complicated tax law.

Moreover, the costs of a complete revision of Subchapter S are many, including but not limited to: (1) legislators' time to prepare, study and enact the bill; (2) the subsequent rewriting of IRS Regulations; and (3) professional tax advisors' services for research on the impact and application of the new legislation. As for the first two of these, the nation's taxpayers have been indicating that they want the cost of government reduced. As for the third, the last thing most small businesses need in the present economic situation is an avoidable upsurge in their legal or accounting fees.

With regard to the proposed changes specifically, we do not believe that it is necessary to increase the permissible number of a Subchapter S Corporation's stockholders from 25 to 35. The number was just increased to 25 by the Economic Recovery Tax Act of 1981. This sort of provision should not be tampered with every year unless there is a demonstrated need. The proposed increased probably represents the growing sentiment against double taxation of corporate profits and dividends and is part of an attempt to move inch by inch to abolish it. Better to face up to that issue directly. In our opinion, Subchapter S should still be for small, very closely held corporations. One member agrees with the change and thinks it would be beneficial to have a definition for a "small business corporation" which all Federal agencies would use.

Other provisions of the Revision Act that do not seem desirable to us and the reasons for our opposing them are:

"Allowing specification of the prospective date for which the revocation of the Subchapter S election will be effective." Basically, this would allow mid-year terminations with the attendant complications involved in allocating income and expense items. Annual terminations are sufficient. One member thinks this provision would be desirable because of the flexibility between Subchapter S and corporate tax years. The computations for allocating income would be no more burdensome than current partnership law. Still, we do not find good business or tax reasons for making the Subchapter S provisions as complex as the partnership rules.

"Permitting corporations of an election on the date the corporation ceased to be a Subchapter S corporation rather than have termination retroactive to the beginning of the year." Again, mid-year terminations would be permitted, unnecessarily. Furthermore, allowing termination to occur on the date of cessation requires the addition of a whole new set of rules and elections that merely add to the complexity of the Code.

"Precluding termination where such termination was inadvertent." This provision would mandate the injection of an IRS judgmental decision as to whether or not the termination was inadvertent. Since that judgment would be influenced by how well the facts were stated, the end result coud be truly inadvertent actions going unapproved while well-stated actions, although not truly inadvertent, were approved. It is far easier to adhere to precisely defined, firm rules.

"Conforming the rules for Subchapter S corporation to those applicable to partnerships." Why conform? Conformity with partnership rules would only add to the corporation's burden of maintaining corporate status. People have become accustomed to working with the long-standing rules governing the Subchapter S corporation, an entity totally different from a partnership. This appears to be change for the sake of change.

On the other hand, we concur with the following proposed changed:

"Eliminating the ability of a new shareholder to terminate a corporation's Subchapter S election by affirmatively refusing to consent to the election." While this could hamper changes in the stockholders of Subchapter S corporations, we favor it because it would prevent a minority interest from controlling the destiny of the majority.

"Permitting revocation of the Subchapter S election to occur at the request of shareholders holding more than ½ of the shares outstanding rather than requiring the consent of 100% of the shareholders." We also favor this because it would allow the wishes of the majority to prevail.

"Changing the period for revocation from one month to 2½ months after the beginning of the year for which effective." The 2½ month period would provide adequate time to make the election to revoke and give a better indication of what the operating results for the year might be than one month does. Further, a date that coincides with the due date of the tax return would be easy to remember and assure that the prior year's results were known. The additional information would facilitate making a decision as to whether or not to revoke a Subchapter S election.

"Change to allow more than 20% of gross receipts as passive income if the corporation has no accumulated earnings and profits." Since the income is taxed to the shareholder in most cases, it is not a sheltering device and this test should be eliminated. If it was a "corporate pocketbook", the Subchapter S would be required to pay the personal holding company tax.

On the issues not covered by the Revision Act upon which the Subcommittee on select revenue measures has requested comments our views are as follows:

"The proper treatment of regular corporations electing Subchapter S." If rules were developed for Subchapter S elections to more closely approximate the treatment of corporations converting to partnerships, immediate taxation of a corporation or its shareholders could occur, in contrast to the situation under current law. This might limit the number of corporations electing Subchapter S status originally and leave less flexibility in long-range tax planning for corporations that would terminate their Subchapter S election.

"Whether the present rule limiting Subchapter S corporations to one class of stock is appropriate." We prefer to have the limitation on one class of stock left as is with the recommendation that Congress exempt small business corporations from the proposed debt equity rules.

"Should the Subchapter S election be available to corporations largely doing business outside of the U.S."? Subchapter S was intended for domestic corporations. Making the Subchapter S election available to corporations largely doing business outside of the U.S. allows corporations a loophole in that if they were a foreign corporation they could now change to qualify for the special tax treatment afforded by Subchapter S. As in other areas, we would oppose a change in its purpose.

In conclusion, we feel that, on balance, most of the proposed changes in Subchapter S that have been written into the Revision Act are either undesirable or unnecessary or both. We do not support changes in the purpose of Subchapter S and we also believe that federal tax laws should be altered as infrequently as possible so that the citizenry may better depend upon them. We are not aware of any good cause to rewrite Subchapter S and suggest that the substantive changes deemed to be of merit be added by revision of the existing Code Sections.

We appreciate the opportunity to comment on this proposed act and would welcome the occasion to discuss it further with you. Please direct any questions to Mary J. Reed at (616) 774-7000 or Carol Gilgen at (319) 268-1193.

Very truly yours,

Mary J. Reed,
Tax Legislation Subcommittee.

Chicago, Ill., *June 15, 1982.*

Re H.R. 6055, the subchapter S, Revision Act of 1982.

John J. Salmon, Esq.,
Chief Counsel, Committee on Ways and Means,
House of Representatives, Washington, D.C.

Dear Mr. Salmon: As a tax practitioner in Chicago, I am writing to urge that the proposals to change the taxation of Subchapter S corporations be changed to permit all corporations, regardless of any accumulated earnings and profits, to elect Subchapter S treatment.

There is no reason to preclude corporations with accumulated earnings and profits from electing the benefits of Subchapter S. Surely precautions can be taken so that the accumulated earnings and profits are taxed as dividends while at the same time permitting a corporation to have its current earnings and profits taxed directly to its shareholders.

If this suggestion is not adopted, I suggest that consideration be given to raising the percentage of passive income that a corporation may earn and still elect Subchapter S treatment. The current limitation of 20 percent is artificially low for many corporations, and I suggest that it be raised to permit corporations to elect Subchapter S even if more than 20 percent of their income is passive income. Raising the limit to 30 or 40 percent would provide some measure of relief to many corporations which would like to elect Subchapter S treatment.

Thank you for your consideration.

Sincerely,

John F. Beggan.

TEXAS A&M UNIVERSITY
COLLEGE OF BUSINESS ADMINISTRATION
COLLEGE STATION, TEXAS 77843-4353
713-845-5014

Department of
ACCOUNTING

COMMITTEE ON
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WAYS AND MEANS

June 13, 1982

John J. Salmon, Chief Counsel
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Re: H.R. 6055 ("The Subchapter S Revision Act of 1982")

Dear Mr. Salmon:

In Rep. Pete Stark's press release of May 13, 1982, on H.R. 6055, he requested public comment on three "issues." I would like to comment on two of these issues.

1. The Proper Treatment of Regular Corporations Electing Subchapter S.

This basic issue involves corporations with accumulated earnings and profits ("AE&P"). H.R. 6055 adopts this approach to such corporations:

*That corporations with AE&P should be permitted to make the Subchapter S election without any mandatory toll charge on the AE&P at either the corporation level or the shareholder level; and

*That the Subchapter S rules for corporations with AE&P and without AE&P should be as close as possible so as to avoid having two separate and distinct kinds of Subchapter S corporations.

I believe that you will find general agreement among concerned persons that the foregoing approach of H.R. 6055 is correct. Accordingly, the discussion below assumes that this approach will be retained and thus is limited to special rules needed for Subchapter S corporations with AE&P.

Subchapter S AE&P. One problem arises out of the fact that many present Subchapter S corporations have AE&P which accumulated during the Subchapter S years (e.g., through IRC Section 312(k)), in contrast to E&P which accumulated in pre-election years. The Secretary of the Treasury should be authorized and directed to promulgate regulations which purge the AE&P that accumulated during Subchapter S years. Such an approach is particularly desirable either if the Subchapter S election could terminate because of the combination of Subchapter S AE&P with excessive passive income (proposed Section 1362(d)(3)) or if existing previously taxed income cannot be withdrawn indefinitely (proposed Section 1379(c)).

Excessive Passive Income. H.R. 6055 views excessive passive income as a problem only in the case of corporations with AE&P. The following rules of H.R. 6055 deal with these kinds of corporations:

*Excessive passive income is present if passive income is at least 20% of the gross receipts (proposed Section 1362(d)(3) and present Section 1372(e)(5)).

*There is a termination of the election if there is excessive passive income (proposed Section 1362(d)(3) and present Section 1372(e)(5)).

*If the termination is inadvertent, a procedure is prescribed for "curing" the termination (that is, restoring the election), but this procedure is not clear for excessive passive income (proposed Section 1362(f)(3) and (4)).
*A new election is permitted after 5 years, but this waiting period may be waived (proposed Section 1362(g) and present Section 1372(f)).

H.R. 6055 should be modified in dealing with passive income, first of all, by tightening up the definition of excessive passive income. The present gross receipts test permits "churning" as a method of avoiding the restrictions. Churning is accomplished principally through dealings in commodities and commodity futures. This tightening up could be accomplished either by adopting a fixed threshold amount (as in present Section 1372(e)(5)(B)(ii)) such as $10,000, by adopting a percentage test based on gross income, or by providing that passive income from the sale of assets is limited to gain therefrom. This writer prefers a fixed threshold amount, such as $10,000, because integration of the threshold amount with the computation of a suggested tax, described below, would be easier.

H.R. 6055 should also be modified in approach to substitute a corporate level tax on excessive passive income (but not other income) in place of termination. The tax approach would have these advantages over the termination approach:

(i) Termination is an excessive penalty. In contrast, a corporate level tax can give a "sting" which is appropriate for the situation and will discourage investments in passive income assets by Subchapter S corpoations with AE&P.

(ii) The steps to soften termination ("curing" and waiver of the 5-year waiting period) do not eliminate termination's overkill. For example, "curing" requires that the termination be inadvertent. It probably will be especially difficult to establish that the second year of excessive passive income is inadvertent. Thus, many industries (such as construction), which typically have consecutive lean years, will not particularly benefit from "curing."

(iii) Termination is very complex in operation. It not only requires a threshold determination, but appropriate steps to soften its effect increase its complexity. In contrast, a corporate level tax can require only one determination--the amount of the tax.

(iv) The corporate level tax is more flexible than termination. For example, the tax could be imposed at progressive rates, thus giving increasing disapproval as the passive income increases.

The drawback to the corporate level tax on excessive passive income is that it might be unpopular, even though it is a better alternative than termination (which imposes a corporate level tax on all income). The unpopularity of the tax would diminish if it were imposed at progressive rates. It should be remembered also that the tax on unrelated business income of exempt organizations has proved to be acceptable. (Nevertheless, if you feel that the tax cannot be accepted, you should consider replacing the "cure" of proposed Section 1362(f) by the suggested tax. Thus, if there were excessive passive income, termination could be avoided by electing a corporate level tax.)

(Please remember that any objections to the tax may in general also be made to the termination approach. For example, it might be contended that it is difficult to define the tax base. Let us remember that the tax can be applied to the same base of "excessive" passive income as any termination approach. For example, the corporate level tax could be applied to the present concept of excessive passive income of Section 1372(e)(5), by imposing a tax on gross receipts from passive income in excess of 20% of total gross receipts. If you view such a base as improper for a tax, then you should likewise view it as improper for the even more drastic termination remedy of present law.)

Letter
To: John J. Salmon, Chief Counsel, Committee on Ways and Means
From: Lorence L. Bravenec
Re: H.R. 6055
June 13, 1982

There are many possible approaches to a corporate level tax. One approach would build on, and modify, the items identified in present Section 1372(e)(5). Another approach would build on, and modify, the concepts of the Personal Holding Company Tax. One major problem has to do with identifying deductions which can be taken in computing the tax base, principally for royalties and rents. As a practical matter, these deductions could be limited to items such as those specified in present Section 543(b)(2). Alternatively, these deductions could be limited to items which are "directly" connected with the passive income, using a concept which is borrowed from Section 514(a)(3). In either case, it is desirable to exempt (or zero rate) the first $10,000 of the tax base,(a) in order to make the tax applicable to excessive amounts of passive income and to integrate the tax with the definition of "excessive" passive income, suggested above.

(No additional special rules are needed for tax exempt interest in the case of an electing corporation having AE&P. A "sting" is already provided by the rules of proposed Section 1368(e)(1)(A).)

Appreciated property. Proposed Section 1363(d) provides that any distribution of appreciated property shall give rise to recognized gain to the Subchpater S corporation. This full recognition rule should be limited to corporations having pre-election AE&P. The rule should be modified so that Subchapter S corporations without pre-election AE&P do not recognize Section 1221 long term capital gain or Section 1231 gain, that is, so that such corporations have to recognize only ordinary income and short term capital gains. Any reason for full recognition in the case of corporations with pre-election AE&P does not appear to be applicable in the case of corporations without pre-election AE&P.

Corporate Tax Imposed on Capital Gains. Similarly, the corporate tax imposed on capital gains (proposed Section 1374 and present Section 1378) should be applicable to corporations having pre-election AE&P, but it should not be applicable to corporations with no AE&P accumulated during pre-election years. Corporations without pre-election AE&P are in a position equivalent to corporations which have never had a "regular" corporation status.

2. Whether the Present Law Limitation of One Class of Stock is Appropriate.

Some type of "one class of stock" limitation is appropriate, in part to deal with the following situations:

*To define clearly who must consent to the election and who has the power to revoke the election; and

*To prevent certain classes of tax avoidance which cannot appropriately be dealt with under other statutory and judicial rules.

(a). See present Section 1372(e)(5)(B)(ii) and proposed Section 1362(d)(3)(B)(ii).

Letter
To: John J. Salmon, Chief Counsel, Committee on Ways and Means
From: Lorence L. Bravenec
Re: H.R. 6055
June 13, 1982

H.R. 6055 takes a desirable step in permitting nonvoting stock and adequately protects the owners of nonvoting stock by requiring their consent to the Subchapter S election.

Debt. The principal one-class-of-stock problem involves purported debt as a second class of stock. The best approach is that classification of debt as a second class of stock terminating the election should be made only as a last resort when there is no adequate statutory or judicial weapon against improper tax avoidance. In this connection, adequate legislative and judicial rules and doctrines exist (or in the case of legislative rules, may be enacted) so that terminations will be required only in a limited number of cases.

Among the present legislative and judicial rules and doctrines which can be used to meet improper tax avoidance through purported debt without terminating the Subchapter S election, are:

*Assignment of income doctrine;
*Family income splitting rules (such as present Section 1375(c) and proposed Section 1366(e));
*Joint venture between the "debtor" and the "creditor;[b]
*Substance over form doctrine; and
*Treatment of the purported debt as non stock equity.[c]

It is suggested that the Treasury Department should promulgate regulations which set out guidelines for identifying limited situations in which the election should terminate. Adequate authority for such regulations exist under present Section 1371(a)(4) (proposed Section 1361(b)(1)(D)). If the Treasury Department does not feel that it has this authority, then the Code should be amended to provide it. In any event, the Committee reports for H.R. 6055 should describe and give support to the eventual regulations. Finally, if any of the suggested existing rules and doctrines are perceived as inadequate to deal with the problems described below, then supplemental legislative rules should be enacted.

(b) See McKee, Nelson & Whitmire, "Federal Taxation of Partnerships and Partners," Par. 3.03(3), p. 3-20.

(c) While there have been "debt v. equity" cases as numerous as the sands of the sea, these have generally involved only the threshold question--"Is purported debt to be classified as debt or as equity?" To this writer's knowledge, only the Subchapter S cases have needed to ask the next question--"Is equity 'debt' to be classified as a second class of stock?" These Subchapter S cases have held that, on their facts, equity "debt" was not to be classified as a second class of stock. See cases cited in T.I.R. 1248 (July 28, 1973) and in Portage Plastics Co., Inc. v. U.S., 486 F.2d 632 (7th Cir. 1973). See also Section 992(a)(1)(C) and Reg. sec. 1.992-1(d)(2) and (3). The writer's previously published opinions on the one class of stock requirement are found in the "The One Class of Stock Requirement of Subchapter S," 6 Houston Law Review 215 (1968).

Letter
To: John J. Salmon, Chief Counsel, Committee on Ways and Means
From: Lorence L. Bravenec
Re: H.R. 6055
June 13, 1982

The following discussion describes the thrust of suggested regulations and also describes possible supplemental legislation.

a. Two step approach. In determining whether purported debt should terminate the election, the regulations should adopt a two step approach. The regulations should first ask: "Is the purported 'debt' to be classified as equity or as debt?" The regulations should approach this question by using the general rules developed under case law and Section 385,(d) or even perhaps by drawing a "bright line" in a manner similar to the DISC one class of stock rules.(e) It is best to use the general rules, because this approach avoids problems with changing the status of debt outstanding at the time of the election. However, it should be made clear that the general rules are to be used only to answer the question whether purported "debt" is debt or equity and not the second question (described below). Moreover, if a "bright line" is to be drawn, it should apply only to post election debt.(f)

If the purported debt is to be classified as equity, the regulations should then ask: "Should the equity 'debt' be considered as stock (which terminates the election if not held pro rata by all shareholders) or as nonstock equity (which does not terminate the election)?" Equity "debt" should terminate the election only if, under the facts, its potential for tax avoidance cannot be adequately prevented by one of the rules or doctrines described previously or by some other rule.(g)

b. Straight debt. In implementing the two step approach, a distinction should be made between "straight" debt and "hybrid" debt. Straight debt has no convertibility or payment-contingency features. Hybrid debt is other debt.

Generally, problems are presented by straight "debt" only if it is classified as equity "debt." Thus, the rules should treat straight "debt" as equity only in exceptional cases. The only possible exceptional case of which the writer is aware involves straight debt pre-existing the Subchapter S election which is equity "debt" under the general rules. Even then, the election should not terminate because of such pre-existing equity "debt."

(d) See note (c) supra.
(e) See section 992(a)(1)(C) and Reg. sec. 1.992-1(d)(2). All factors found in the DISC regulations, however, are not appropriate. For example, if the rate of interest between related parties is not arms' length, then a special allocation could be used to solve the problem. See discussion relating to Example 1 in the text.
(f) But cf. Reg. sec. 1.992-1(d)(2).
(g) In a comparable situation, DISC Reg. sec. 1.992-1(d)(3), it is speculated, was reserved for this kind of determination.

Pre-existing straight equity "debt" could be adequately dealt with either (i) by continuing the equity classification of pre-election years (but without taking the second step of treating the "debt" as a second class of stock) or (ii) by applying debt classification during the period of the election. Please note, however, that if the equity classification continues to apply, "interest" payments would not be deductible and both "interest" and "principal" payments could be taxed as distributions out of AE&P under such sections as 301 and 302. Further, if the alternative treatment of debt classification is to apply, the transformation from equity to debt classification by virtue of making the Subchapter S election should not be treated as a recapitalization.

c. Hybrid debt. The most intractable problems are presented by hybrid debt. This subject is discussed through the use of examples:

Example 1: Income shifting through convertibility. Assume that A (a high incremental rate taxpayer) and B (a low incremental rate taxpayer or a taxpayer with excessive deductions for the current year) form a corporation which makes the Subchapter S election. A invests $10,000 and gets convertible debt which pays interest at a rate below an arms' length rate. B invests $10,000 in stock. In this example, B will be taxed on income which will eventually benefit A, but only because the interest rate on the "debt" is unrealistically low.

Alternatively, B invests $10,000 in convertible debt which pays interest at a rate above arms' length. A invests $10,000 in stock. In this alternative example, A in effect is assigning income to B.

If A and B are members of the same family, proposed Section 1366(e) should adequately meet any tax avoidance attempts between family members, and thus termination is not required.

If A and B are not members of the same family, the best solution is to provide an arms' length rate of interest and not to terminate the election. It is suggested that proposed Section 1366 be expanded to add a new subsection "(g)" to provide for an arms' length interest rate between a Subchapter S corporation and a 2% shareholder,(h) with stock that could be acquired under an option, warrant, or convertible debt, being treated as if it had been so acquired in determining 2% ownership.

Example 2: Substitute for gross income allocation. Assume that C and D have a partnership in which the first $100,000 of income is allocated to C, with the balance being divided between C and D. They wish to incorporate, make the Subchapter S election, and provide a similar result to the partnership allocation by using convertible debt.

(h) See proposed Section 267(f) under H.R. 6055.

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From: Lorence L. Bravenec
Re: H.R. 6055
June 13, 1982

It is felt that the scheme of C and D is not improper as long as the rate of interest is arms' length. Accordingly, the solution described under "Example 1" above is relevant here.

Example 3: Potential misallocation of loss deductions. Assume that E and F form a corporation which makes the Subchapter S election. E invests $1,000 for stock and $9,000 for convertible debt. F invests $10,000 for convertible debt which is junior to E's debt. Here E will be able to claim all losses, even though the losses might be borne in part by F's investment (when funds are adequate to pay all or part of E's senior debt but not F's junior debt).

Alternatively, the parties use straight debt and options and warrants instead of convertible debt.

In this case, it is submitted, the problem arises out of the fact that F's debt is junior to E's. If, under the substance over form doctrine, F is held to be a shareholder (that is, F is treated as if he converted his debt), the problem would disappear. Alternatively, there could be a special statutory rule, perhaps as a modification of Section 465, which would deny the deductiblility of losses if economically borne by another person having convertible debt.

If should be recognized that there could be misallocation of loss deductions through options and warrants even though debt is not involved. For example, assume that it is projected that a business will have operating losses during its first three years. G desires to sell these losses to H. The business is incorporated with H as the sole shareholder, with G having an option to purchase H's shares, and with G as the manager of the business. It is contemplated that G will exercise the option after the business becomes profitable. Is there not a misallocation of loss deductions in this example? It is submitted, therefore, that the solution to misallocation of loss deductions is not to terminate the election, but to fashion an appropriate judicial or statutory doctrine which deals directly with such misallocation.

Example 4: Mischaracterization of income. Assume that a tax exempt organization, a nonresident alien, a foreign corporation, or a dummy thereof, takes an interest in debt providing for interest based on profits. If the income is characterized as interest, it could escape taxation in whole or in part.

An appropriate doctrine to prevent mischaracterization of income is the "joint venture" doctrine. Under this doctrine, the arrangement is treated as a tax partnership, and the creditor has trade or business income instead of interest income. It is this writer's opinion that courts would be more willing to prevent mischaracterization of income by applying the joint venture doctrine than by terminating the election. If the Committee staff disagrees with the writer's expression of certitude, please consider as a

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statutory solution that contingent interest is to be treated as a payment out of the residual amount under proposed Section 1366(a)(2), generally giving rise to business income to the "creditor" and a business deduction to the "debtor."

It is conceivable that hybrid "debt" could be held by ineligible shareholders such as corporations, partnerships, and ineligible trusts or that the number of shareholders and hybrid "debt" creditors in a corporation might exceed the maximum number of permitted shareholders. However, these situations apparently do not give rise to tax avoidance problems, other than those discussed previously, which are so serious as to require termination of the election.

Restricted stock. Another serious one-class-of-stock problem is created when there is stock subject to a buy-sell agreement or to an option, when other stock is in effect not subject to such an agreement; that is, it is restricted stock.(i) Such restrictions are likely to be present when the stock is issued for services.

The following matters relating to restricted stock should be clarified by the new law or the committee reports. Using the rationale of the *Parker Oil Co.* decision,(j) restricted stock should not present termination problems, if any restrictions are imposed by virtue of shareholder agreement and not by virtue of corporate charter or state law. Even if the restrictions are imposed by virture of state law or corporate charter, they do not represent a threat to the integrity of Subchapter S if there is a formula buyout price based on book value or on a reasonable multiple of earnings likely to give the shareholder the benefit of undistributed net profits which have been taxed to him.(k) Moreover, a restriction imposed by state law on stock taken by promoters, does not seem to represent a threat to the integrity of Subchapter S, as long as the restriction is imposed for the benefit of investors.

It is my hope that the foregoing observations will be useful to you and the Committee staff in drafting legislation which de-emphasizes termination of the election. If I can be of further assistance, please let me know.

The opinions expressed in this letter are entirely the writer's and do not purport to represent the opinions of Texas A&M University, of any client of the writer's, or of any organization of which the writer is a member.

Sincerely,

Lorence L. Bravenec
Professor of Accounting

LLB:db

(i) See Reg. sec. 1.83-3(c).
(j) *Parker Oil Co., Inc.*, 58 T.C. 985 (1972) (acq. in result only).
(k) See Reg. sec. 1.83-5(a).

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Department of
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July 1, 1982

John J. Salmon, Chief Counsel
Committee on Ways and Means
U. S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Re: H.R. 6055 ("The Subchapter S Revision Act of 1982")

Dear Mr. Salmon:

I would like to supplement my letter of June 13, 1982, relating to H.R. 6055.

The Committee on Ways and Means should give strong consideration to modifying proposed Section 1361(b)(1)(B) and (2)(A) so as to permit a parent-subsidiary Subchapter S election when (i) both corporations make the election, (ii) both corporations have the same taxable year, and (iii) the subsidiary is 100% owned by the parent.

The suggested modification makes sense under a complete flowthrough approach, which will be adopted under the Act.

The suggested modification would be of particular benefit to interstate businesses. At present, if it is desired to conduct an operation in another state through a separate corporation, the parent must own less than 80% and others must own more than 20% of the stock of the subsidiary. It would be very useful if there could be 100% ownership.

No tax avoidance potential is perceived under the suggested modification. Problems may be presented, however, if nonshareholders have debt instruments with equity features, but these problems relate to debt generally and are not unique to the suggested modification.

The suggested modification contemplates that a "tandem" election will be made by the parent and the subsidiary. Thus, if the election of one terminates, the election of the other likewise terminates.

The Committee might also want to give consideration to extending the suggested modification to 80% ownership situations and/or to extending the suggested modification to permit an election by a corporation when all of its stock is owned by two or more Subchapter S corporations. I make no recommendation on these extensions, because I have not had an opportunity to give them sufficient thought.

If I can be of further assistance, please let me know.

Sincerely,

Lorence L. Bravenec
Prof. of Accounting

THE COLORADO BAR ASSOCIATION
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June 9, 1982

Mr. John J. Salmon
Chief Counsel
House Ways & Means Committee
United States House of Representatives
1102 Longworth Building
Washington, D.C. 20515

Dear Mr. Salmon:

In accordance with the notice published in the Federal Register requesting comments regarding the "Subchapter S Revision Act of 1982" (S 2350 and HR 6055), we hereby enclose our comments regarding the proposed legislation and respectively request that such comments be considered in preparing the legislation for final enactment.

As a general principle, we highly favor enactment of the Subchapter S Revision Act of 1982. The general thrust of the legislation would greatly expand the scope and utility of Subchapter S Corporations and also simplify the tax treatment accorded their shareholders. In the interest of further simplifying and clarifying various aspects of the proposed legislation, we respectively submit our comments, which for purposes of organization are presented under the following headings: (1) Eligibility; (2) Election, Revocation and Termination; (3) Tax Treatment of Shareholders; (4) Adjustment to Shareholders' Stock Basis; (5) Distributions; and (6) Oil and Gas Depletion.

ELIGIBILITY

1. Regulated Investment Companies ("RICs") and Real Estate Investment Trusts ("REITs")

Among other requirements, existing Section 1371(a) defines a small business corporation as a domestic corporation which is not a member of an affiliated group as defined in Section 1504. Section 1504(b)(6) specifies that the term "includable corporation" (not generally permitted to elect Subchapter S status) means any corporation except a RIC and a REIT subject to Subchapter M of Chapter 1 of the Code. However, Section 1361(b)(2)(A) of the proposed legislation specifies that the term "ineligible corporation" means any corporation which is a member of an affiliated group determined without regard to Section 1504(b) of the Code. Proposed Section 1361(b)(2) then goes on to exclude certain corporations that are not intended to fall within the definition of a small business corporation. See proposed Section 1361(b)(2)(A) to (E). However, proposed Section 1361(b)(2) does not exclude a RIC and a REIT from the definition of a small business corporation. Furthermore, Subchapter M of the Code does not prevent a RIC or a REIT from qualifying under Subchapter S of the Code. As a result, the legislation should clarify whether or not it is actually intended to exclude RICs and REITs from the proposed provisions of Subchapter S.

2. Domestic International Sales Corporations ("DISC")

Under existing Subchapter S law, it is possible that the stock of a DISC could be owned by a Subchapter S Corporation without jeopardizing the Subchapter S election. In the context of an affiliated group, Subchapter S status is denied only to an "includable corporation" within the meaning of Section 1504(b). Since Section 1504(b)(7) excludes a DISC or former DISC from the definition of "includable corporation" it is possible that a Subchapter S Corporation could own stock in a DISC without violating its Subchapter S status. See Private Letter Ruling 8220130. Although stock ownership in and of itself, under existing law, will not jeopardize Subchapter S status, excessive passive income or foreign source income generated by the DISC may indeed cause a termination of an otherwise qualified Subchapter S election.

Proposed Section 1361(b)(2)(E) would specifically prevent a DISC or former DISC from qualifying as a "small business corporation." We submit that such a restriction would unduly hamper the small businessman from utilizing the benefits normally provided a larger corporation in dealing with foreign purchasers. Furthermore such a restriction does not provide an incentive to the small businessman to expand his operations to foreign markets which might otherwise assist attainment of a more favorable balance of payments. As a result we strongly urge that the proposed legislation permit S Corporations the flexibility of utilizing a DISC to market its products or services to foreign purchasers.

3. Technical Corrections Act of 1982 Amendment

Section 102(i) of the Technical Corrections Act of 1982 would amend Section 1371(g) of the Code to clarify that a trust required to distribute all of its income currently, as well as a trust which actually distributes all of its income currently to a sole income beneficiary may qualify as a shareholder in a Subchapter S Corporation. The bill would also clarify that the distribution requirement applies with respect to income as defined under Section 643(b) of the Code which incorporates a definition of income by reference to local law. We support the above proposed amendment to existing law and also urge that proposed Section 1361(d)(3)(B) which incorporates the provisions of Section 102(i) of the Technical Corrections Act of 1982, be retained.

4. Issuance of Restricted Stock to Employees

Under existing law it has always been uncertain whether or not the issuance of restricted stock to employees of a Subchapter S Corporation would invoke the second class of stock restriction imposed by Section 1371(a)(4). In Private Letter Ruling 8129116, the Internal Revenue Service ruled that the existence of such a restrictive stock agreement would not render the stock a second class of stock under Section 1371(a)(4). In the interest of providing certainty in this area, it would be beneficial if the new legislation specifically confirmed the fact that the issuance of such restrictive stock does not constitute the issuance of a second class of stock.

5. Beneficial Stock Ownership

Existing provisions of Subchapter S do not specifically address whether beneficial ownership of Subchapter S stock will qualify. Treas. Reg. 1.1371-1(d)(1) provides that "[p]ersons for whom a stock in a corporation is held by a nominee, agent, guardian or custodian will generally be considered shareholders of the corporation." The proposed legislation as presently drafted does not address the question of beneficial ownership of S Corporation stock. In order to provide certainty in this area, it would be beneficial if the proposed legislation were to specifically provide that the mere holding of stock as a nominee, agent, guardian or custodian will be considered ownership of S Corporation stock by those persons for whom such stock is held in a representative capacity. Such a provision might adopt a title ownership approach that requires designation or identification of the beneficial owners in order to assure compliance with the maximum shareholder requirement of proposed Section 1361(b)(1)(A). Furthermore, this rule should be subject to and be integrated with the proposal set forth below regarding Partnerships (see Number 6 infra). Not only would such a provision provide certainty, but it would also remove any doubt as to the effect of the prior regulations with respect to the proposed legislation if enacted.

6. Partnership Shareholders

A closely related question to the beneficial stock ownership issue has arisen in the context of whether individual partners or their partnerships own stock in a Subchapter S Corporation. Case law has developed addressing the question of whether or not stock actually issued in the name of an individual is in fact beneficially owned by a partnership entity. For example, in Kates v. Commissioner, 27 T.C.M. 1423 (CCH) (1968), the Tax Court held that stock issued in the name of an individual was based upon the facts of the case beneficially owned by a partnership thus invalidating the Subchapter S election. This case should be compared with Guzowski v. Commissioner, 26 T.C.M. 666 (CCH) (1967) where the Tax Court held that stock that was issued in the name of a partnership was in fact owned by the partners individually because the partnership was found to have terminated. See also, Ozier v. Commissioner, 36 T.C.M. 236 (CCH) (1977), aff'd., 600 F.2d 594 (6th Cir. 1979).

Due to the inherently factual and subjective analysis applicable in this area, it is imperative that some certainty be provided. For example, it would be helpful if the proposed legislation adopted a strict title ownership approach to stock issued to a partnership or its partners. Such an approach would basically take the position that the name in which such stock is issued determines the party holding the stock for purposes of determining S Corporation eligibility. Under existing law, the issuance of Subchapter S shares to individual partners constitutes a trap for the unwary which may retroactively terminate the Subchapter S election by virtue of a facts and circumstance analysis conducted at a date subsequent to the issuance of such shares with the benefit of hindsight.

7. Momentary Ownership and the Reorganization Provisions

Under existing law, it is unclear whether or not the momentary ownership of stock in a Subchapter S Corporation, by another corporation pursuant to a reorganization transaction, will jeopardize Subchapter S status. Neither the existing statute or the proposed legislation specifically address this issue. In Rev. Rul. 72-320, 1972-1 C.B. 270, the Service ruled that in the context of a Section 368(a)(1)(D) reorganization (spin-off), that the momentary ownership, by a Subchapter S Corporation, of all the stock of another corporation would not jeopardize Subchapter S status. Furthermore, in Rev. Rul. 73-496, 1973-2 C.B. 312, the Service ruled that a Subchapter S election would not terminate in the context of a Section 332, Section 334(b)(2) liquidation if the acquiring Subchapter S Corporation liquidates the acquired corporation within 30 days of the purchase of the stock. Furthermore, in Private Letter Ruling 7812051, the Service indicated that its informal position was that any period of ownership longer than 30 days will not be considered qualifying "momentary ownership." In the interest of providing certainty to shareholders engaged in a reorganization transaction involving a Subchapter S Corporation, it would be extremely beneficial if the proposed legislation were to adopt an objective time period (i.e., 30 days) in which the momentary ownership of stock would not jeopardize an otherwise valid S Corporation election, if the S Corporation is involved in a qualified corporate reorganization requiring monetary stock ownership.

8. Liquidation Status

Under existing Subchapter S law, the Service has attacked the availability of Subchapter S status if the corporation involved is in the process of winding up its affairs or liquidating. For example, in Hauptman v. Director of Internal Revenue, 309 F.2d 62 (2nd Cir. 1962), cert. denied, 372 U.S. 909 (1963), the court stated that "the likelihood that an otherwise qualifying corporation may be liquidated is not a factor that should be considered in order to justify a judicial restriction upon the right to elect the tax treatment Congress granted by Subchapter S." Id. at 65. Although existing Section 1371(f) provides that the term "estate" includes the estate of an individual subject to Title 11 of the United States Code, neither the existing statute nor the proposed legislation specifically addresses whether or not Subchapter S status or S Corporation status, respectively, is available to a corporation undertaking a liquidation. A provision adopting this view would serve to establish the precedential value of existing case law with respect to the newly enacted legislation.

ELECTION, REVOCATION AND TERMINATION

1. Foreign Source Income Restriction

Both the existing Subchapter S statute, and the proposed legislation, retain the restriction that an election of Subchapter S or S Corporation status respectively would be terminated if the corporation derives more than 80% of its gross receipts from sources outside the United States. In light of the fact that S Corporation status is restricted to domestic corporations owned by United States taxpayers, there does not appear to be any logical reason for discouraging the expansion of small business into foreign markets. There is absolutely no risk that the income generated by the S Corporation would not be taxed currently to United States shareholders. As a result, there is no risk that income earned in foreign jurisdictions would avoid repatriation to the United States taxing jurisdiction. As a result, we strongly recommend that the foreign source income limitation be deleted from the proposed legislation.

2. Passive Investment Income Limitation

Both the existing Subchapter S statute and the proposed legislation provide (with certain exceptions) that a Subchapter S or S Corporation election respectively will be terminated if the corporation has gross receipts for any taxable year more than 20% of which constitute passive investment income. One exception to the above rule, as provided by existing law and the proposed legislation, provides that the generation of passive investment income for such taxable year in an amount which is less than $3,000 will not jeopardize Subchapter S or S Corporation status. In light of today's inflationary economy, we submit that the $3,000 passive investment income exception does not accurately reflect existing economic conditions. As a result we favor increasing the *de minimis* exception from $3,000 to $6,000.

3. Gross Receipts Clarification

In Rev. Rul. 79-294, 1979-2 C.B. 305, the Service held that for purposes of Section 1371(e)(5), the amount of gross receipts realized by a small business corporation from trading in commodity futures equals the gains that result from the difference between the contract prices of positions and the contract prices of the respective positions required to close the initial position unreduced by any fee or commission. The Service offers little or no authority for its conclusion stated in the ruling. In fact, the Service has apparently sought, by virtue of Rev. Rul. 79-294, to engraft the Personal Holding Company provisions of Treas. Reg. 1.543-1(b)(6) (regarding limitations on gross income in transactions including commodities) and Treas. Reg. 1.543-2 (regarding gains from futures transactions in commodities) onto the Subchapter S regulations which contain rules regarding determination of gross receipts from the sale of stock or securities, but not commodities. See Treas. Reg. 1.1372-4(b)(5)(x). Furthermore, Rev. Rul. 79-294 is completely at odds with Rev. Rul. 71-568, 1971-2 C.B. 312 where the Service held that a commodity futures contract did not constitute a "stock or security" for purposes of Section 1091 of the Code. In light of the recent legislation contained in the Economic Recovery Tax Act (ERTA) of 1981, regarding straddles and other regulated futures contracts, it would be extremely beneficial if the proposed legislation were to clarify the impact that trading in commodities has with respect to generation of gross receipts in the context of S Corporations.

TAX TREATMENT OF SHAREHOLDERS

1. Characterization of Shareholder Items

Section 1366(b) of the proposed legislation entitled "Character Passed Thru" provides that "[t]he character of any item included in a shareholder's pro rata share under paragraph (1) of subsection (a) shall be determined as if such item were realized directly from the source from which realized by the corporation, or incurred in the same manner as incurred by the corporation." Due to the fact that the proposed legislation exhibits a significant shift toward the partnership form of doing business, we view it imperative that the proposed legislation clarify whether or not the aggregate or entity concept is to be applied with respect to characterizing items of S Corporation income. Under the proposed legislation, it is unclear whether or not the characterization of an item will be determined solely at the corporate level, or whether or not the activity of a particular shareholder may influence such characterization.

For example, the language utilized in proposed Section 1366(b) is very similar to the language utilized by the Service in Rev. Rul. 67-188, 1967-1 C.B. 216, wherein the Service stated "[t]he character of any such item included in a partner's distributive share shall be determined as if the item were realized by the partner directly from the source from which realized by the partnership or incurred in the same manner as incurred by the partnership." However, characterization at the partner level is apparently inconsistent with the Supreme Court's recent decision in United States v. Basye, 410 U.S. 441 (1973) where the court stated that for purposes of calculating partnership income, "the partnership is regarded as an independently recognizable entity apart from the aggregate of its partners." As a result of the proposed legislation's shift toward the partnership form of doing business, we submit that the proposed legislation should clarify that S Corporation items are to be characterized at the corporate level without regard to shareholders. This position is supported further by the historical fact that the corporate entity has been viewed by the law as a separate and distinct legal entity separate and apart from its shareholders. In the interest of providing security for taxpayers in this regard, we recommend that the proposed legislation clarify the issue of whether an aggregate or entity concept should govern in the area of S Corporations.

2. Special Allocations

The proposed legislation does not provide that an S Corporation may specially allocate items of income, gain, loss, deduction or credit among its shareholders in a fashion that is similar to the partnership concept contained in Section 704 of the Code. We strongly urge that careful consideration be given to adopting a special allocation format with respect to S Corporations. Indirectly, such an allocation format can be achieved under existing law by the utilization of a partnership of Subchapter S Corporations and providing for special allocations at the partnership level. Furthermore, the proposed S Corporation legislation adopts provisions similar to Section 702 (regarding the distributive share of each partner's specifically designated item of income and deductions) and Section 705 (regarding the determination of a partner's basis in his partnership interest) already in place with respect to partnerships. It would not be difficult to implement a provision similar to Section 704(b), which provides for special allocations in the context of S Corporations. Such a provision would increase the flexibility of such corporations, and avoid the necessity of forming a partnership of S Corporations to accomplish the same objectives.

Due to adoption of the partnership basis provisions, and adoption of the partnership method of allocating separable items of income and deductions to the shareholders, it would be possible for the proposed legislation to integrate the current requirements imposed by existing case law regarding a determination of whether or not "substantial economic effect" occurs with respect to a special allocation. The proposed legislation could provide that: (1) the shareholders must adopt the equivalent of capital account accounting; (2) that distributions be made in accordance with such pseudo-capital accounts; and (3) in the event that any negative balance were to arise, the shareholders would be liable to the corporation in such amount or alternatively suffer a reduced distribution upon liquidation. If adoption of a special allocation format in the context of S Corporations is deemed feasible, the proposed legislation should specifically define what it means by "substantial economic effect" so that taxpayers can dispense with the need for additional interpretive case law in this area. The best situation would be to adopt existing case law with respect to a definition of "substantial economic effect."

3. Family Partnership Rules

The proposed legislation adopts the family partnership rules set forth in Section 704(e) with respect to shareholders who render services for or furnish capital to the corporation without receiving reasonable compensation therefor. In this regard, the Secretary is given substantial authority to make adjustments in items taken into account by such individuals as may be necessary to reflect the value of such services or capital. See Proposed Section 1366(e). One of the primary factors involved in the family partnership area is whether or not capital utilized in the business constitutes a material income-producing factor. Prior to the Tax Court's decision in Carriage Square, Inc., 69 T.C. 119 (1977), it was believed, based on prior case law, that the determining factor was the existence of capital in the trade or business. However, after Carriage Square, it appears that the existence of capital is not as important a factor as the source of the capital. In Carriage Square, the Tax Court held that in order for capital to be considered a material income-producing factor with respect to a limited partnership, the capital had to be contributed by the partners and not borrowed from a third party. In this regard the Court stated, "[w]hile borrowed capital, under other circumstances, may be 'capital' for Section 704(e)(1) purposes, we hold that it is not in this instance." Eleven judges disagreed with the majority opinion's treatment of the borrowed capital issue and one concurring opinion and two opinions dissented in part. In the context of S Corporations, with the likelihood that the corporation would utilize borrowed funds, it is imperative that the new law address the uncertainty raised by the _Carriage Square_ case. We submit that it should not matter whether the capital involved was contributed directly from the personal wealth of a partner or borrowed from a third party.

ADJUSTMENT TO SHAREHOLDERS' STOCK BASIS

1. Timing of Basis Adjustment

New proposed Section 1367 sets forth the rules that govern adjustment to basis of the stockholders with respect to their stock in a S Corporation. However, nowhere in the proposed statute is it made clear at what time such basis adjustment is required. In light of the adoption of many partnership rules in the context of S Corporations, we recommend that the adjustment be required at year-end in conformity with Treas. Reg. 1.705-1(a)(1).

2. Drawing Account or S Corporation Equivalent

The proposed statute, although adopting many of the partnership principles of Subchapter K, does not indicate whether a S Corporation would be able to utilize a drawing account. Due to the close similarities presently existing in the proposed statute and Subchapter K, we recommend that a drawing account analogy be provided in the proposed legislation. Such a drawing account could be compatible with the shareholders' basis adjustments with respect to their stock. Furthermore, utilization of a drawing account would facilitate the recording of interim draws from the corporation during the year.

DISTRIBUTIONS

New proposed Section 1368 sets for the rules regarding distributions of property made by a S Corporation with respect to its stock. The provisions set forth therein indicate that any amount of a distribution which exceeds the adjusted basis of the shareholders' stock shall be treated as gain from the sale or exchange of property. In the interest of clarity, we recommend that a cross-reference be set forth in the statute which indicates whether or not a determination of capital gain status with respect to the excess distribution is also subject to the rules of Section 341. Arguably, proposed Section 1371 entitled "Coordination with Subchapter C" would provide some support for the view that Section 341 would apply to recharacterize any distribution which exceeds the adjusted basis of the stock under Section 1368. However, a quick cross-reference in the proposed statute may dispense with unnecessary litigation on this point.

OIL AND GAS DEPLETION

A proposed amendment to Section 613A(c)(13)(C) as set forth in the proposed statute indicates that an election by a C Corporation to become a S Corporation will be treated as a transfer of all its properties effective on the day on which such election first takes place with respect to existing Section 613A(c)(9). However, this provision is directly contrary to Rev. Rul. 80-43, 1980-1 C.B. 133, in which the Service ruled that an election to be treated as a small business corporation under Section 1372(a), is not a transfer within the meaning of Section 613A(c)(9) of an interest in any proven oil or gas property. In that ruling the Service stated that a "transfer" of any proven oil or gas property means a change in legal or equitable ownership in the oil or gas property. Any change that increases a taxpayer's proportionate share of income from an oil or gas property is also a transfer. The Service went on to note that the filing of an election under Section 1372(a) of the Code does not cause a transfer of legal or equitable ownership of any property from or to the corporation. The corporation owns the same oil and gas properties before and after the election. Furthermore, the shareholders of an electing small business corporation do not receive a disproportionate share of income from oil or gas properties as a result of the election. As a result, the ruling concluded that a transfer had not occurred for purposes of Section 613A(c)(9).

The same theory should apply equally in the context of the new proposed statute. A C Corporation owning proven oil and gas properties, would still own the same properties subsequent to an election under the proposed statute. Furthermore, no shareholder would receive a disproportionate share of income from the oil and gas properties as a result of the election. Therefore, we submit that the proposed statute should be amended to reflect the fact that no transfer occurs by virture of an election by a C Corporation to become a S Corporation.

Furthermore, the proposed statute does not indicate the effect of a S Corporation becoming a C Corporation either by reason of revocation or termination of the election. Rather, the proposed statute only provides that transfers by individuals to corporations under Section 351, where a S Corporation becomes a C Corporation, will be treated as if each individual shareholder had transferred to such corporation his pro rata share of all the assets of the S Corporation. The same theory discussed above should also apply in the context of a change from S Corporation status to C Corporation status.

We respectfully request that careful consideration be given to the above comments. We believe that implementation of the above comments would provide additional clarity and security for taxpayers seeking to utilize S Corporation status in the event the proposed legislation is enacted substantially as now proposed.

Very truly yours,

Robert A. Wherry, Jr.,
Chairman of the Tax Section

Theodore Z. Gelt

Theodore Z. Gelt,
Vice-Chairman of the Tax Section

Neil M. Goff

Neil M. Goff

cc: Charles Turner

NMG/hf

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June 21, 1982

The Honorable Fortney H. Stark
Chairman
Subcommittee on Select Revenue Measures
Committee on Ways and Means
1102 Longworth House Office Building
Washington, D.C. 20515

Re: H.R. 6055, Subchapter S Revision Act of 1982

Dear Mr. Chairman:

On June 14, 1982, your subcommittee held a hearing on H.R. 6055. The proposed legislation seeks to simplify the tax rules relating to eligibility and operation of subchapter S corporations. We are concerned about an issue not addressed in that bill. It relates to problems created by the application to subchapter S corporations of the investment tax credit at risk rules enacted by the Economic Recovery Tax Act of 1981. A copy of the statement we are submitting for the record of the hearing on H.R. 6055 is enclosed for the review of yourself and your staff.

Sincerely,

G. N. Buffington

GNB:mdk

Enclosure

cc: The Honorable Barber B. Conable
The Honorable Daniel Rostenkowski
John J. Salmon, Esq.

Application of At Risk Limitation on Investment Tax Credit to Subchapter S Corporation Shareholders

Since enactment of the Internal Revenue Code of 1954, the tax law has provided small operating businesses with a simplified tax structure as "subchapter S corporations" that permits the flexibility to build internally generated capital to support future growth. As a result, these subchapter S corporations are involved in virtually every aspect of small business in the United States. Further encouraging small business in this direction, Chairman Rostenkowski and Congressman Conable have co-sponsored H.R. 6055, the Subchapter S Revision Act of 1982. The purpose of the bill is to simplify further the tax rules related to eligibility for subchapter S status as well as the operation of subchapter S corporations. Thus, there seems to be an expressed intent of concerned members of Congress to make the subchapter S corporation a more useful and attractive vehicle for small business. A provision included in the Economic Recovery Act of 1981 ("ERTA") has created a serious problem for taxpayers desiring to use the subchapter S corporation for the very type of business operation that should be encouraged. While only a few taxpayers have yet raised the issue, as experience under ERTA develops, the problem will be recognized as quite broad in scope.

The ERTA provision in question is the so-called "at risk" limitation on the investment tax credit in section 46(c)(8) of the Code. The at risk concept first came into the law under the Tax Reform Act of 1976 and was designed to prevent a taxpayer from deducting losses in excess of his actual economic investment in the activity involved. This limitation is included in section 465 of present law. Initially, the limitation applied only to a specific number of activities which were commonly associated with tax shelter investments. In 1978, the at risk limit on deductions was broadened to include any business activity (except real estate and certain equipment leasing activities of closely held corporations). Finally in 1981, the at risk limitation was extended to the investment tax credit. The tax policy served by this last step in the expansion of the at risk rule is unclear. What is clear, however, is that the rule as it is likely to be applied will result in a major restraint on the use of subchapter S corporations by legitimate operating businesses.

As can be seen from the series of broadening amendments after 1976, the at risk limitation has diverged from its original purpose, i.e. to limit tax shelters. It is not entirely clear that the extent to which the at risk concept has diverged from its original purpose was fully appreciated by the Congress. Certainly the legislative history of the broadening at risk concept discusses it as if it were focused on preventing or limiting non-economic tax shelter operations. Nevertheless, under present law, the extent of the taxpayer's investment commitment, measured in a particular way, rather than the nature of his business activity, determines the applicability of the at risk limitation. To the extent that the investment credit at risk limitation discourages the formation and growth of legitimate operating businesses as subchapter S corporations, it should be re-examined, and either repealed or modified to express a more sharply defined policy objective.

The principal question is whether or not a shareholder of a subchapter S corporation must be at risk with respect to an investment financed in whole or in part by full recourse debt incurred by the corporation. Read literally, section 46(c)(8) seems to say that if the financing qualifies for at risk at the corporate level, it will be considered at risk at the shareholder level. Unfortunately, considerable doubt is created by contrary conclusions reached in statements included in the Joint Committee on Taxation staff explanation prepared after enactment.

To describe the problem more technically, subparagraph (B) of section 46(c)(8) defines the "amount at risk." As a general rule, clause (i) of subparagraph (B) provides that the amount at risk is determined under section 465(b). An alternative rule is provided under clause (ii). Under the latter test, the taxpayer will be considered to be at risk with respect to third party debt, including nonrecourse debt, if the taxpayer is at risk "at all times" under section 465(b) to the extent of at least 20 percent of the basis of section 38 property. Special rules applicable under clause (ii) require that such financing be furnished by an unrelated party.

The 20 percent at risk requirement in clause (ii) was not included in this legislation until it was added by the Senate in a floor amendment during the final days of Congressional consideration of ERTA. The purpose of the eleventh hour change was to assure that no third party nonrecourse debt would be counted as at risk unless the taxpayer had a minimum 20 percent at risk investment in the property without regard to the limitation. Obviously, no hearings were held on the possible side effects of this limitation. Under subparagraph (C), the clause (ii) at risk rule applies to shareholders of subchapter S corporations (as well as partners), and it is here that the ambiguity in the statute lends itself to conflicting interpretations.

Under subparagraph (C), a special rule provides that "the amount treated as at risk under subparagraph (B)(ii) shall be allocated among . . . shareholders (and treated as an amount at risk with respect to such persons) . . ." The General Explanation of ERTA prepared by the staff of the

Joint Committee on Taxation contains the following interpretation of this language in the context of limited partners whose status is comparable for this purpose to that of subchapter S shareholders:

> "For purposes of applying the first exception, any debt of a partnership or subchapter S corporation incurred with respect to eligible property will be treated as the debt of the partners or shareholders and will be allocated among the partners or shareholders according to the rules for allocating the investment credit (Treas. Reg. § 1.46-3(f)). For example, an amount borrowed with respect to eligible property by a general partner on a recourse basis would be allocated among all the partners. A limited partner's share of such a borrowed amount would be considered, for purposes of the first exception, as an amount borrowed by the limited partner for which the limited partner has no personal liability to make repayment. Therefore, the limited partner would not be at risk for this amount under the general rule, but if the requirements of the first exception are otherwise satisfied by the limited partner, the limited partner will be considered to be at risk with respect to his allocable share of the amount borrowed by the general partner. If the requirements of the first exception are not otherwise met by the limited partner, for example if the limited partner does not have a minimum 20-percent at-risk investment (determined under the general rule) in his share of the property, the first exception would not apply and the limited partner would not be considered to be at risk with respect to the amount borrowed by the general partner."

It is difficult to see how subchapter S corporation shareholders could ever be at risk in a typical business situation with this interpretation of the law.

First, many subchapter S corporations are capitalized with something less than a 20 percent stockholders' at risk investment computed under section 465(b). This may be due to favorable lending terms, to the fact that appreciation in asset values is ignored for the purpose of the at risk calculation and to many other factors. Under such circumstances, shareholders would not be at risk with respect to property investments of the corporation and would, therefore, receive no investment credit even though their business is clearly at risk.

Second, in the case of a profitable subchapter S corporation which distributes its entire taxable income each year, the stockholder will have a zero basis and never be able to claim an investment tax credit. This problem arises as a result of the interaction between the subchapter S tax regime which requires a basis reduction for distributed income and the at risk rules which fail to provide for any attribution of corporate basis to shareholders. In effect, such treatment requires a subchapter S corporation to retain undistributed income in order to qualify its shareholders for any investment credit. The result is clearly an unwarranted discrimination against this category of taxpayers.

Finally, the statute provides absolutely no guidance as to how an allocation to shareholders of either assets or corporate capital would be made to implement this rule. Under paragraph 8 of section 46(c), the investment tax credit is limited to the basis of property with respect to which the taxpayer is at risk. Thus, unlike the limitation on deductions under section 465, which relates to an activity or business, the at risk limitation of section 46(c)(8) is determined on a property by property basis. Where capital is not specifically related to a particular asset or where an investment by one taxpayer is attributed to another, as in the case of subchapter S corporations, application of the limitation requires a mechanism for allocating the investment to a particular property. This involves a major complexity of both technical and policy proportions not present in section 465.

It is important to realize that every subchapter S corporation whose business operations involve a significant investment in section 38 property may encounter this problem. A number of situations in which subchapter S corporation shareholders are precluded by section 46(c)(8) from claiming an investment tax credit have already arisen, and as experience under ERTA evolves further, many more are likely to emerge. A case which has characteristics typical of the general problem has been brought to our attention and is summarized as follows.

A subchapter S corporation (herein referred to as the Company) has been engaged in the car rental business since 1975. The Company has nine stockholders, eight of whom are active in business operations as officers or directors and almost 1,000 employees with an annual payroll of approximately

$10 million. Total revenues of the Company for 1981 were approximately $77 million. Net worth at year end 1981 was a little less than $6 million.

The Company provides automobiles primarily for non-business use through airline and travel agency referrals in Florida, California, Colorado, Arizona, Nevada and Georgia. With each rental car, the Company provides substantial services such as fueling, cleaning, maintenance and delivery and insurance.

To enable the Company to compete successfully with its larger more established competitors, part of the corporate strategy for growth has been to rely largely on the finance affiliates of the major car manufacturers to provide funds to replace and expand its rental fleet. The Company currently purchases about 18,000 new automobiles every 12 to 14 months. This represents a recurring investment in section 38 property of about $50 million. These finance affiliates have been willing to lend to the Company (on a full recourse basis) 100 percent of the cost of the cars purchased, provided that the Company continues to meet certain minimum net worth tests. Under ERTA, the cars are considered three year property, and the maximum investment tax credit for such property is six percent if held for the full three years. Because the Company holds the cars for less than two years, it is entitled under ERTA to a credit of only two percent.

Under the at risk limitation as it is likely to be interpreted, no investment credit would be allowed the Company's shareholders. The shareholders probably will not be considered to have made any at risk investment with respect to the automobiles purchased because they are 100 percent financed by non-shareholder investment. Even if this is not the case, it is unlikely that the shareholders individually will meet the 20 percent at risk requirement. Assuming the investment of $50 million represented by the purchase price of cars is allocated to the shareholders ratably as their proportionate investment in section 38 property, their aggregate at risk investment would have to be $10 million. The shareholders' $6 million of equity invested in the Company is only 12 percent of the $50 million investment and, therefore, the shareholders would fail the 20 percent minimum investment test.

Recommendations

Several approaches to solving this problem could be considered. First, the at risk limitation adopted by ERTA could be modified by creating a special exclusion for all taxpayers, including subchapter S corporations, which are engaged in the active conduct of a trade or business as distinct from a tax shelter operation. Such an exclusion could be modelled on the exclusion from the section 465 at risk rules of certain equipment leasing corporations. See section 465(c)(4).

Second, section 46(c)(8) could be amended to make it clear that both subchapter S corporations and partnerships would be tested for at risk purposes only at the partnership or corporate level. Indeed, we believe that this is a reasonable interpretation of the present section 46(c)(8). We are attaching two alternative amendments which would make such a clarification.

Third, if a more limited exclusion is deemed appropriate, section 46(c)(8) could be amended to provide for a single corporate level at risk test if the corporation meets a reasonable trade or business test. Two alternative approaches to this modificaton are also attached.

We would prefer the first approach of simply providing an exclusion from the entire at risk limitation on the investment tax credit for any taxpayer which meets an appropriate operating business test. Whatever the policy objectives of the ERTA at risk rule may be, we believe Congress viewed the enactment of such a restrictive rule as necessary only in the context of tax shelters and continues to support the incentive of the investment tax credit for legitimate business enterprises.

Alternative I

(Long Form)

Section 46(c)(8)(C) is amended as follows:

(C) SPECIAL RULE FOR PARTNERSHIPS AND SUBCHAPTER S CORPORATIONS.- In the case of any partnership or electing small business corporation (within the meaning of section 1371(b)), any amount treated as at risk under subparagraph (B)(ii) shall be allocated among the partners or shareholders (and treated as an amount at risk with respect to such taxpayers) in the same manner as the credit allowable by section 38. No taxpayer who treats an amount as at risk under the preceding sentence shall be required to be at risk under this paragraph with respect to such amount separately in the capacity of partner or shareholder. [Amendment language underscored.]

Alternative II

(Short Form)

Section 46(c)(8)(C) is amended as follows:

(C) SPECIAL RULE FOR PARTNERSHIPS AND SUBCHAPTER S CORPORATIONS.- In the case of any partnership or electing small business corporation (within the meaning of section 1371(b)), any amount treated as at risk under subparagraph (B)(ii) shall be allocated among the partners or shareholders (and for purposes of this paragraph treated as an amount at risk with respect to such taxpayers) in the same manner as the credit allowable by section 38. [Amendment language underscored.]

Alternative I

Amend section 46(c)(8)(C) by designating the first sentence as clause (i) and adding the following clause (ii) -

(ii) Special Rule for Active Trade or Business - In the case of a partnership or electing small business corporation (within the meaning of section 1371(b)), the partners of a partnership and the shareholders of the small business corporation shall be allocated the amount at risk determined at the partnership or corporation level, respectively, in the same manner as the credit allowable by section 38, if, on the basis of all the facts and circumstances, the partnership and the small business corporation are engaged in an active trade or business.

Alternative II

Amend section 46(c)(8)(C) by designating the first sentence as clause (i) and adding the following clause (ii) -

(ii) Exception Where Tax Shelter Characteristics Not Present - In the case of a partnership or electing small business corporation (within the meaning of section 1371(b)), the partners of a partnership and the shareholders of the small business corporation shall be allocated the amount at risk determined at the partnership or corporation level, respectively, in the same manner as the credit allowable by section 38 for any taxable year during which it is determined that -

(I) amounts borrowed and included in such amounts at risk are "borrowed amounts" within the meaning of section 465(b)(2),

(II) borrowed amounts conform to standard commercial practices in the taxpayer's trade or business,

(III) the value of property with respect to which such amounts at risk are determined is not subject to substantial uncertainty, and

(IV) interests in the partnership or corporation are not marketed to prospective investors as a tax shelter.

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June 18, 1982

John J. Salmon, Esquire
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United States House of Representatives
1102 Longworth House Office Building
Washington, D. C. 20515

SUBCOMMITTEE
JUN 23 1982

Re: H.R. 6055 (the "Subchapter S Revision Act")

Dear Mr. Salmon:

I write to suggest that the Subchapter S Revision Act be amended to provide for an amendment to Section 170(b)(2) of the Internal Revenue Code of 1954 (the "Code") which would exclude Subchapter S corporations from the limitation on charitable contribution deductions of a corporation. Presently, Section 170(b)(2) provides that the total charitable contribution deductions of all corporations in any taxable year shall not exceed 10 percent of taxable income (computed without regard to specified items). The charitable contributions of an individual in a taxable year are limited by Section 170(b)(1) to 50 percent of his contribution base with respect to some charities and 20 percent of his contribution base with respect to others. Excess contributions of corporations and excess contributions of individuals to "50 percent charities" can be carried over for five succeeding taxable years.

The stated intent of the Subchapter S Revision Act is to treat Subchapter S corporations for tax purposes in a manner similar to partnerships so that individual items of income and loss will pass through to shareholders with the same character as if realized by the shareholder directly.

COMMITTEE ON
RECEIVED
JUN 21 1982
WAYS AND MEANS

Currently, a Subchapter S corporation computes its taxable income in roughly the same manner as a regular corporation and its charitable contributions are subject to Section 170(b)(2). The items of income and deduction of a partnership, on the other hand, including its charitable contributions, are passed through to the partners and there is no limitation on the charitable contribution deduction at the partnership level. Code, Section 702(a)(4). The charitable contributions of a partnership are considered in determining whether an individual partner has exceeded the limitations set forth in Section 170(b)(1). Treas. Reg. Section 1.702-1(a)(3).

If the conduit theory of taxation is to be adopted with respect to Subchapter S corporations, there is no good reason why such corporations should be subject to the charitable contribution limitation set forth in Section 170(b)(2). If the suggested amendment were adopted, the policy of Congress contained in Section 170(b)(2) that charitable contribution deductions of an individual in a single year be limited would continue to apply. Moreover, the suggested amendment would serve the bill's purpose of:

(a) simplifying the rules relating to the operation of Subchapter S corporations and eliminating traps for the unwary; and

(b) treating Subchapter S corporations and their shareholders more like partnerships and their partners.

Would you please include this letter in the materials to be considered as a part of the Committee's hearings on the bill.

Thank you.

Sincerely yours,

John L. W. Garrou

JLWG:pk

cc: C. Clinton Stretch, Esquire
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May 27, 1982

John J. Salmon, Esquire, Chief Counsel
Committee on Ways and Means
U. S. House of Representatives
1102 Longworth House Office Building
Washington, D. C. 20515

Re: HR 6055
Sub-Chapter S Revision Act
of 1982

Dear Mr. Salmon:

In our area there are a few small companies organized many years ago, during the late eighties and into the early part of the nineteen hundreds, to acquire mineral estates, primarily coal lands in Southwest Virginia, Southern West Virginia and East Tennessee. After many years these companies are beginning to realize some income from mineral royalties, much of which is minimum royalties for the right to extract the minerals. These companies have small investments, and income is considered to be passive income. These companies are primarily family owned now by the third and fourth generation and have very little accumulated and undistributed earnings.

I feel that the receipt of so call passive income coming from rents, royalties and investments should not deprive this kind of a corporation from qualifying as a Sub-Chapter S corporation.

Any consideration given to this proposal will be very much appreciated.

Yours very truly,

John W. Gillespie

John W. Gillespie

JWG/nd

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June 16, 1982

JUN 17 82

The Honorable Fortney H. "Pete" Stark
Chairman
Subcommittee on Select Revenue Measures of
House Ways and Means Committee
1034 Longworth Building
Washington, D.C. 20515

Re: H. R. 6055

Dear Mr. Stark:

I am writing on behalf of the Insurance Exchange of the Americas, Inc. to comment on a provision of the proposed Subchapter S Revision Bill of 1982 (H.R. 6055) and some possible consequences it may hold for our new business enterprise which is now emerging in the State of Florida. We want to be sure that the Subcommittee is aware of the implications of one provision in the Bill. We would respectfully request that, if possible, this letter be incorporated in the public record of the recent Subcommittee hearing conducted on this Legislation on June 16, 1982. We are grateful for this opportunity to express our concerns.

The Insurance Exchange of the Americas, headquartered in Miami, Florida is one of several Lloyd's of London-type enterprises established in recent years in this country. Our Exchange is scheduled to begin active operation in the latter part of this year. The enabling legislation was enacted by the Florida Legislature in 1979. Since then we have reached the time the Exchange will be in a position to commence operations by the end of the year.

Inasmuch as insurance exchanges are a fairly recent development in this country, perhaps a brief description is in order. As in the case of Lloyd's of London, the Exchange is a marketplace where member syndicates will negotiate insurance and reinsurance contracts through underwriters which they employ. Business will be brought to the Exchange by brokers seeking coverage for their clients. The syndicates are an essential element to the operation of the Exchange and they consist of individuals or groups of investors who combine their resources, in the form of capital, to engage in the business of underwriting risks for a price - the premium.

The Insurance Exchange of the Americas, Inc. itself is a non-profit corporation which provides various administrative and support services to the syndicates who transact their business within the facilities provided.

When the concept was generated by the Florida Legislature it was the Legislature's expressed aim that an insurance facility of this nature should attract foreign investment dollars to the United States (to capitalize syndicates) and should attract insurance business premium (both direct insurance and reinsurance) from other countries and especially from Latin America and the Caribbean for which the state is well situated.

It was felt that this particular type of business operation would mesh well with Florida's rapidly growing international banking, financial and trade sectors. Moreover, it was felt that as a new form of invisible exporting of services from the United States the presence of a viable insurance exchange would lead to the creation of a large number of new jobs as well as greater business opportunities and needs for other services of all kinds. In insurance and reinsurance terms there is a real need for such a contribution to our economy.

To date, the evidence is increasingly strong that precisely those anticipated results will be achieved as the Exchange proceeds toward opening its doors later this year as stated above.

We are confident that the Exchange of the Americas will create a broad spectrum of new job opportunities in Florida in both management, professional and clerical level positions and will attract the substantial foreign capital and result in the export of a wide range of insurance related services to other countries we set out to achieve.

The issue to which we invite the Subcommittee's attention, is generated by language located in Section 1361(b) (2) (c) of H.R. 6055 . The Bill's current language excludes from application of Subchapter "S" Corporations: "an insurance company subject to tax under Subchapter L". This language significantly modifies existing law by preventing the Subchapter S corporation vehicle from being used by persons desiring to engage in not only life insurance (which is consistent with existing law) but also casualty insurance. Under current law casualty insurance companies are permitted to use the Subchapter S election [Rev. Rul. 74-437, 1974-2 C.B. 274], assuming the other general requirements for Subchapter S are met. It is this exclusion of casualty insurance companies from possible Subchapter S status that concerns us because we feel that it is likely to impede our ability to fulfill our aims.

The rationale behind the current law preventing life insurance companies from electing Subchapter S status is easily distinguished and separately justifiable from casualty insurance companies. Life insurance companies are, practically speaking, unable to elect Subchapter S status due to the "passive income test". H.R. 6055 proposes to eliminate the passive income test and to substitute several blanket exclusions for it. However, H.R. 6055's insurance company exclusion goes beyond the scope of the current law and expands the prohibition to include casualty companies as well as life companies. Casualty companies are not precluded by the passive income test from electing Subchapter S status.

The reason for our concern is positive for we have had considerable interest evidenced by prospective syndicate investors who have indicated a desire to utilize the Subchapter S corporate vehicle for their syndicate. The law change currently embodied in the quoted language from H.R. 6055 has caused several such prospective syndicates to delay their plans to participate in our Exchange until the outcome on the Bill is known. There have been we know several additional possible syndicates beyond these which have planned to organize as Subchapter S corporations since it is permissible under existing law. This point is only of interest to syndicate insurers and does not impinge on others. Removal of this form of business organization from those available to prospective syndicates would, we respectfully suggest, unnecessarily complicate our efforts to create an insurance exchange in Florida, as well as similar efforts elsewhere in this country.

Syndicates operating at Lloyd's of London enjoy various kinds of tax advantages which are not available in this country. While we do not seek new tax advantages for United States Exchanges, we urge caution on the Subcommittee's part before available business vehicles, especially ones which would provide some modest tax incentives to syndicate investors, are removed and we seek your help in earning foreign income for our country. We urge the Subcommittee not to undermine our ability to compete for investor monies in syndicates.

Part of our objectives in this country is to repatriate U.S. dollars and, in addition, create foreign investment income and foreign insurance business. Therefore, we suggest that now is not the time to materially alter the ground rules governing the forms of business organization through which insurance business can be conducted. The insurance exchange concept is new and young enough in development for the elimination of the Subchapter S election to reduce the number of syndicates ultimately generated, thereby reducing the volume of business conducted by the exchanges and their rate of maturity in a highly competitive world marketplace.

This issue is especially important to the Insurance Exchange of the Americas, which is essentially developing along the lines of the Lloyd's model in the sense that our syndicates have a high attraction for individual investors. It is for this reason that we are making this effort to apprise you of our concern and to solicit the Subcommittee's favorable consideration of either of the alternative solutions which we propose below.

The simplest way to resolve the matter would be to exclude syndicates of insurance exchanges from application of the exclusion. At a minimum, syndicates engaging in non-life insurance should be excluded.

Another alternative would be to amend the exclusion to apply only to life insurance companies, as opposed to all insurance companies. Such an amendment would, in fact, conform the language in the Bill to what we understand current law to be.

We would be happy to work with the Subcommittee and staff to provide any further information or opinions you may deem appropriate. We would be most happy to have someone in attendance at your markup session, when that occurs. We have taken the liberty of enclosing with this letter a copy of the enabling legislation for the insurance Exchange of the Americas, which might be helpful to an understanding of our concerns.

Thank you for this opportunity to express our concerns relative to H.R. 6055. We hope that the Committee will view our proposals favorably.

Very truly yours,

Alan Teale
President

AT:ap

History.—§ 700, ch. 59-205; §§ 13, 35, ch. 69-106.

§ 629.401 Insurance exchange

(1) There may be created one or more insurance exchanges, with one or more offices each, subject to such rules as may be promulgated by the commissioner. For the purposes of this section, the term "exchange" shall apply to any such insurance exchange proposed or created under this section. The purposes of the exchange are:

(a) To provide a facility for the underwriting of:

1. Reinsurance of all kinds of insurance.

2. Direct insurance of all kinds of risks located entirely outside the United States.

3. Surplus lines insurance eligible for export under § 626.916 or § 626.917 and placed through a licensed Florida surplus lines agent.

(b) To manage the facility authorized by this section, in accordance with rules promulgated by the commissioner.

(2) The operation of this subsection shall become effective with respect to any exchange only after a determination by the Insurance Commissioner and Treasurer that the exchange may operate in an economic and beneficial manner. A committee shall be appointed to write the constitution and bylaws of the proposed exchange, to make such other recommendations as may be necessary to assure maximum coordination of the operations of the exchange with existing insurance industry operations, and to assure maximum economic benefits to the state from the operations of the exchange. The committee shall consist of 13 members, 6 to

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be appointed by the Insurance Commissioner and Treasurer, 2 each to be appointed by the Speaker of the House of Representatives and the President of the Senate, 1 each to be appointed by the minority leader of the House of Representatives and the minority leader of the Senate, and 1 to be the Insurance Commissioner and Treasurer or his designated representative. The chairman shall be elected by a majority of the committee. The committee shall transmit such proposed constitution and bylaws and such other recommendations to the Insurance Commissioner and Treasurer and to the Legislature no later than 5 days prior to the adjournment of a regular annual legislative session or no later than 5 days prior to the commencement of any special or organizational legislative session. Subject to the disapproval of the constitution and bylaws by either house of the Legislature by resolution before the end of such legislative session, the exchange shall have full authority to function pursuant to its constitution and bylaws 60 days after the end of the session. The initial board of governors of the exchange shall consist of 14 members, 3 appointed by the Insurance Commissioner and Treasurer, 3 by the Speaker of the House of Representatives, 3 by the President of the Senate, 1 by the minority leader of the House of Representatives, 1 by the minority leader of the Senate, and 3 by the Governor, to serve until the first election pursuant to the constitution or bylaws.

(3) The constitution and bylaws of the exchange shall provide for, but shall not be limited to:

(a) The election of no fewer than 6 nor more than 13 governors, at least one-third of whom shall not be members of the exchange and who shall be public representatives.

(b) The location of the principal offices of the exchange and the principal offices of its members to be within this state for the purpose of the transaction of the type of business described in subsection (1). A principal office shall be one where officers and qualified personnel who are engaged in the administration, underwriting, claims, policyholders' service, marketing, accounting, recordkeeping, and all supportive services shall be located.

(c) The submission by members and all applicants for membership on the exchange of such financial information as may be required by the commissioner.

(d) The establishment by the exchange of a security fund in such form and amount as approved by the commissioner.

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(e) The voting power of members who are underwriting syndicates.

(f) The voting power and other rights granted under the provisions of the not-for-profit corporation law, chapter 617, to participate in the conduct and management of the affairs of the exchange, by brokers, agents, and intermediaries transacting business on the exchange, each of whom shall be considered "members" only under the provisions of such law.

(g) The rights and duties of exchange members, which may include, but shall not be limited to, the manner and form of conducting business, financial stability, dues, membership fees, mandatory arbitration, and all other matters necessary or appropriate to conduct any business permitted herein.

Any amendments to the constitution and bylaws shall be subject to the approval of the commissioner.

(4) Any insurance exchange formed under the provisions of this section shall not be subject to any state or local taxes or fees measured by income, premiums, or gross receipts, except that for purposes of taxation under § 624.509 direct premiums written, procured, or received by a member or members through the exchange on risks located in this state shall be construed to be written, procured, or received by the exchange, and the premium tax due on said premium shall be reported and paid by the exchange.

(5) The exchange shall reimburse the commissioner for any expenses incurred by the department relating to the regulation of the exchange and its members.

(6)(a)1. The provisions of §§ 625.012 and 625.031 shall be applicable to the underwriting members of an exchange in the same manner as those sections apply to domestic insurers authorized to do business in this state.

2. The provisions of §§ 625.302-625.339 shall be applicable to the underwriting members of an exchange in the same manner as those sections apply to domestic insurers authorized to transact business in this state.

(b) In addition to the insurance laws specified in paragraph (a), the department shall regulate the exchange pursuant to the following powers, rights, and duties:

1. General examination powers.—The department shall examine the affairs, transactions, accounts, records, and assets of any security fund,

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exchange, members, and associate brokers as often as it deems advisable. The examination may be conducted by the accredited examiners of the department at the offices of the entity or person being examined. The department shall examine in like manner each prospective member or associate broker applying for membership in an exchange.

2. Departmental approval and applications of underwriting members. —No underwriting member shall commence operation without the approval of the department. Before commencing operation, an underwriting member shall provide a written application containing:

a. Name, type, and purpose of the underwriting member.

b. Name, residence address, business background, and qualifications of each person associated or to be associated in the formation or financing of the underwriting member.

c. Full disclosure of the terms of all understandings and agreements existing or proposed among persons so associated relative to the underwriting member, or the formation or financing thereof, accompanied by a copy of each such agreement or understanding.

d. Full disclosure of the terms of all understandings and agreements existing or proposed for management or exclusive agency contracts.

3. Investigation of underwriting member applications.—In connection with any proposal to establish an underwriting member, the department shall make an investigation of:

a. The character, reputation, financial standing, and motives of the organizers, incorporators, or subscribers organizing the proposed underwriting member.

b. The character, financial responsibility, insurance experience, and business qualifications of its proposed officers.

c. The character, financial responsibility, business experience, and standing of the proposed stockholders and directors, or owners.

4. Notice of management changes.—An underwriting member shall promptly give the department written notice of any change among the directors or principal officers.

5. Alternate financial statement.—In lieu of any financial examination, the department may accept an audited financial statement.

6. Correction and reconstruction of records.—If the department finds

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any accounts or records to be inadequate, or inadequately kept or posted, it may employ experts to reconstruct, rewrite, post, or balance them at the expense of the person or entity being examined if such person or entity has failed to maintain, complete, or correct such records or accounts after the department has given him or it notice and reasonable opportunity to do so.

7. Obstruction of examinations.—Any person or entity who or which willfully obstructs the department or its examiner in an examination is guilty of a misdemeanor of the second degree, punishable as provided in § 775.082, § 775.083, or § 775.084.

8. Filing of annual statement.—Each underwriting member shall, annually on or before March 1, or within such extension of time therefor as the department for good cause may have granted, file with the department a full and true-statement of its financial condition, transactions, and affairs as of the preceding December 31.

9. Record maintenance.—Each underwriting member shall have and maintain its principal place of business in this state and shall keep therein complete records of its assets, transactions, and affairs in accordance with such methods and systems as are customary for or suitable to the kind or kinds of insurance transacted.

10. Examination of agents.—If the department has reason to believe that any agent, as defined in § 626.041, § 626.051, § 626.062, or § 626.914, has violated or is violating any provision of the insurance law, or upon [1]receipt of a written complaint signed by any interested person indicating that any such violation may exist, the department shall conduct such examination as it deems necessary of the accounts, records, documents, and transactions pertaining to or affecting the insurance affairs of such agent.

11. Written reports of department.—The department or its examiner shall make a full and true written report of any examination. The report shall contain only information obtained from examination of the records, accounts, files, and documents of or relative to the person or entity examined or from testimony of individuals under oath, together with relevant conclusions and recommendations of the examiner based thereon. The department shall furnish a copy of the report to the person or entity examined not less than 30 days prior to filing the report in its office. If such person or entity so requests in writing within such 30-day period, the department shall grant a hearing with respect to the report

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and shall not file the report until after the hearing and after such modifications have been made therein as the department deems proper.

12. Admissibility of reports.—The report of an examination when filed shall be admissible in evidence in any action or proceeding brought by the department against the person or entity examined, or against his or its officers, employees, or agents. The department or its examiners may at any time testify and offer other proper evidence as to information secured or matters discovered during the course of an examination, whether or not a written report of the examination has been either made, furnished, or filed in the department.

13. Withholding reports.—The department may withhold from public inspection any examination or investigation report for so long as it deems reasonably necessary to protect the person or entity examined from unwarranted injury or to protect the public interest.

14. Publication of reports.—After an examination report has been filed, the department may publish the results of any such examination in one or more newspapers published in this state whenever it deems it to be in the public interest.

15. Consideration of examination reports by entity examined.—After the examination report of an underwriting member has been filed, an affidavit shall be filed with the department, not more than 30 days after the report has been filed, on a form furnished by the department and signed by the person or a representative of any entity examined, stating that the report has been read and that the recommendations made in the report will be considered within a reasonable time.

16. Examination costs.—Each person or entity examined by the department shall pay to the department the expenses incurred in such examination.

17. Exchange costs.—An exchange shall reimburse the department for any expenses incurred by it relating to the regulation of the exchange and its members, except as specified in subparagraph 16.

18. Powers of examiners.—Any examiner appointed by the department, as to the subject of any examination, investigation, or hearing being conducted by him, may administer oaths, examine and cross-examine witnesses, and receive oral and documentary evidence, and shall have the power to subpoena witnesses, compel their attendance and testimony, and require by subpoena the production of books, papers, records,

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files, correspondence, documents, or other evidence which he deems relevant to the inquiry. If any person refuses to comply with any such subpoena or to testify as to any matter concerning which he may be lawfully interrogated, the Circuit Court of Leon County or the circuit court of the county wherein such examination, investigation, or hearing is being conducted, or of the county wherein such person resides, on the department's application may issue an order requiring such person to comply with the subpoena and to testify; and any failure to obey such an order of the court may be punished by the court as a contempt thereof. Subpoenas shall be served, and proof of such service made, in the same manner as if issued by a circuit court. Witness fees and mileage, if claimed, shall be allowed the same as for testimony in a circuit court.

19. False testimony.—Any person willfully testifying falsely under oath as to any matter material to any examination, investigation, or hearing shall upon conviction thereof be guilty of perjury and shall be punished accordingly.

20. Self-incrimination.—

a. If any person asks to be excused from attending or testifying or from producing any books, papers, records, contracts, documents, or other evidence in connection with any examination, hearing, or investigation being conducted by the department or its examiner, on the ground that the testimony or evidence required of him may tend to incriminate him or subject him to a penalty or forfeiture, and the person notwithstanding is directed to give such testimony or produce such evidence, he shall, if so directed by the department and the Department of Legal Affairs, nonetheless comply with such direction; but he shall not thereafter be prosecuted or subjected to any penalty or forfeiture for or on account of any transaction, matter, or thing concerning which he may have so testified or produced evidence, and no testimony so given or evidence so produced shall be received against him upon any criminal action, investigation, or proceeding; except that no such person so testifying shall be exempt from prosecution or punishment for any perjury committed by him in such testimony, and the testimony or evidence so given or produced shall be admissible against him upon any criminal action, investigation, or proceeding concerning such perjury, nor shall he be exempt from the refusal, suspension, or revocation of any license, permission, or authority conferred, or to be conferred, pursuant to the insurance law.

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b. Any such individual may execute, acknowledge, and file in the office of the department a statement expressly waiving such immunity or privilege in respect to any transaction, matter, or thing specified in such statement, and thereupon the testimony of such individual or such evidence in relation to such transaction, matter, or thing may be received or produced before any judge or justice, court, tribunal, grand jury, or otherwise; and if such testimony or evidence is so received or produced, such individual shall not be entitled to any immunity or privileges on account of any testimony so given or evidence so produced.

21. Penalty for failure to testify.—Any person who refuses or fails, without lawful cause, to testify relative to the affairs of any member, associate broker, or other person when subpoenaed and requested by the department to so testify, as provided in subparagraph 18., shall, in addition to the penalty provided in subparagraph 18., be guilty of a misdemeanor of the second degree, punishable as provided in s. 775.082, s. 775.083, or s. 775.084.

22. Name selection.—No underwriting member shall be formed or authorized to transact insurance in this state under a name which is the same as that of any authorized insurer or is so nearly similar thereto as to cause or tend to cause confusion or under a name which would tend to mislead as to the type of organization of the insurer. Before incorporating under or using any name, the underwriting syndicate or proposed underwriting syndicate shall submit its name or proposed name to the department for the approval of the department.

23. Capitalization.—An underwriting member shall provide an initial paid-in capital and surplus of $1,500,000 and thereafter shall maintain a minimum policyholder surplus of $1,000,000 in order to be permitted to write all kinds of insurance other than life insurance and annuities or, alternatively, life insurance, annuities, and accident and health insurance. An underwriting member shall provide an initial paid-in capital and surplus of $3,000,000 and thereafter maintain a minimum policyholder surplus of $2,000,000 in order to be permitted to write all kinds of insurance. Except for that portion of the paid-in capital and surplus which shall be maintained in a security fund of an exchange, the paid-in capital and surplus shall be invested by an underwriting member, in a manner consistent with ss. 625.301-625.340. The portion of the paid-in capital and surplus in any security fund of an exchange shall be invested in a manner limited to investments for life insurance companies under the Florida insurance laws.

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24. Limitations on coverage written.—No underwriting member shall expose itself to any loss on any one risk in an amount exceeding 10 percent of its surplus to policyholders. An underwriting member shall not write additional risks if either its ratio of net premiums written to surplus as to policyholders exceeds 8.5 to 1 or the writing of such risks would produce a ratio of net premiums written to surplus as to policyholders of more than 8.5 to 1. Any risk or portion of any risk which shall have been reinsured in an assuming reinsurer authorized to do such business in this state shall be deducted in determining the limitation of risk prescribed in this section. This subparagraph shall not apply to the insurance of marine risks, marine protection and indemnity risks, or workers' compensation or employer's liability risks, nor to certificates of title, guaranties of title, or policies of title insurance. For the purpose of determining the limitation of risk, surplus as to policyholders shall be deemed to include any voluntary reserves, or any part thereof, which are not required by or pursuant to law and shall be determined from the last sworn statement of such underwriting member on file with the department pursuant to law, or by the last report or examination filed by the department, whichever is more recent at the time of assumption of such risk.

25. Unearned premium reserves.—All unearned premium reserves for business written on the exchange shall be calculated on a monthly or more frequent basis or on such other basis as determined by the department; except that all premiums on any marine or transportation insurance trip risk shall be deemed unearned until the trip is terminated.

26. Loss reserves.—All underwriting members of an exchange shall maintain loss reserves. The reserves shall be subject to review by the department; and if loss experience shows that an underwriting member's loss reserves are inadequate, the department shall require the underwriting member to maintain loss reserves in such additional amount as is needed to make them adequate.

27. Distribution of profits.—An underwriting member shall not distribute any profits in the form of cash to owners except out of that part of its available and accumulated surplus funds which is derived from realized net operating profits on its business and realized capital gains. Such payments to owners shall not exceed 30 percent of such surplus in any one year unless otherwise approved by the department. Nothing in this subparagraph shall in any way limit, or be applicable to, payments

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out of an underwriting member's net operating profits and realized capital gains derived during the immediately preceding calendar year.

28. Stock dividends.—A stock dividend may be paid by an underwriting member out of any available surplus funds in excess of the aggregate amount of surplus advanced to the underwriting member under subparagraph 30.

29. Dividends from earned surplus.—A dividend otherwise lawful may be payable out of an underwriting member's earned surplus even though the total surplus of the underwriting member is then less than the aggregate of its past contributed surplus resulting from issuance of its capital stock at a price in excess of the par value thereof.

30. Borrowing of money by underwriting members.—

a. An underwriting member may borrow money to defray the expenses of its organization, provide it with surplus funds, or for any purpose of its business, upon a written agreement that such money is required to be repaid only out of the underwriting member's surplus in excess of that stipulated in such agreement. The agreement may provide for interest not exceeding 20 percent simple interest per annum. The interest shall or shall not constitute a liability of the underwriting member as to its funds other than such excess of surplus, as stipulated in the agreement. No commission or promotion expense shall be paid in connection with any such loan. The use of any surplus note shall be subject to the approval of the department.

b. Money so borrowed, together with the interest thereon if so stipulated in the agreement, shall not form a part of the underwriting member's legal liabilities except as to its surplus in excess of the amount thereof stipulated in the agreement, nor be the basis of any setoff; but until repayment, financial statements filed or published by an underwriting member shall show as a footnote thereto the amount thereof then unpaid, together with any interest thereon accrued but unpaid.

31. Liquidation, rehabilitation, and restrictions.—The department, upon a showing that a member or associate broker of an exchange:

a. Is impaired or insolvent;

b. Has, by contract of reinsurance or otherwise, transferred substantially its entire property or business, or entered into any transaction the effect of which is to merge substantially its entire property into the property or business of any other individual, firm, corporation, or entity,

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without having first obtained the written approval of the commissioner; however, a member may merge or consolidate its operation with another operation if it meets any applicable requirements of Florida law governing mergers and if such action is approved by the commissioner;

c. Is found, after an examination, to be in such condition that its further transaction of business will be hazardous to its policyholders, to its creditors, or to the public;

d. Has become the subject of any procedure for liquidation or bankruptcy; or

e. Has failed to qualify or to maintain its qualification as a member of an exchange; may restrict sales by type of risk, policy or contract limits, premium levels, or policy or contract provisions; increase surplus or capital requirements of underwriting members; issue cease and desist orders; suspend or restrict a member's or associate broker's right to transact business; place an underwriting member under conservatorship or rehabilitation; or seek an order of liquidation as authorized by part I of chapter 631.

32. Prohibited conduct.—The following acts by a member, associate broker, or affiliated person shall constitute prohibited conduct:

a. Fraud.

b. Fraudulent or dishonest acts committed by a member or associate broker prior to admission to an exchange, if the facts and circumstances were not disclosed to the department upon application to become a member or associate broker.

c. Conduct detrimental to the welfare of an exchange.

d. Unethical or improper practices or conduct, inconsistent with just and equitable principles of trade as set forth in, but not limited to, §§ 626.951-626.9641, 626.973, and 626.988.

e. Failure to use due diligence to ascertain the insurance needs of a client or a principal.

f. Misstatements made under oath or upon an application for membership on an exchange.

g. Failure to testify or produce documents when requested by the department.

h. Willful violation of any law of this state.

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i. Failure of an officer or principal to testify under oath concerning a member, associate broker, or other person's affairs as they relate to the operation of an exchange.

j. Violation of the constitution and bylaws of the exchange.

33. Penalties for participating in prohibited conduct.—

a. The department may order the suspension of further transaction of business on the exchange of any member or associate broker found to have engaged in prohibited conduct. In addition, any member or associate broker found to have engaged in prohibited conduct may be subject to reprimand, censure and/or a fine not exceeding $25,000 imposed by the department.

b. Any member which has an affiliated person who is found to have engaged in prohibited conduct shall be subject to involuntary withdrawal or in addition thereto may be subject to suspension, reprimand, censure and/or a fine not exceeding $25,000.

34. Reduction of penalties.—Any suspension, reprimand, censure, or fine may be remitted or reduced by the department on such terms and conditions as shall be deemed fair and equitable.

35. Other offenses.—Any member or associate broker that is suspended shall be deprived, during the period of suspension, of all rights and privileges of a member or of an associate broker and may be proceeded against by the department for any offense committed either before or after the date of suspension.

36. Reinstatement.—Any member or associate broker that is suspended may be reinstated at any time on such terms and conditions as the department may specify.

37. Remittance of fines.—Fines imposed under this section shall be remitted to the department and shall be paid into the Insurance Commissioner's Regulatory Trust Fund.

38. Failure to pay fines.—When a member or associate broker has failed to pay a fine for 15 days after it becomes payable, such member or associate broker shall be suspended, unless the department shall have granted an extension of time to pay such fine.

39. Changes in ownership or assets.—In the event of a major change in the ownership or a major change in the assets of an underwriting member, the underwriting member shall report such change in writing

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to the department within 30 days of the effective date thereof. The report shall set forth the details of the change. Any change in ownership or assets of more than 5 percent shall be considered a major change.

40. Retaliation.—

a. When by or pursuant to the laws of any other state or foreign country any taxes, licenses, or other fees, in the aggregate, and any fines, penalties, deposit requirements, or other material obligations, prohibitions, or restrictions are or would be imposed upon an exchange or upon the agents or representatives of such exchange which are in excess of such taxes, licenses, and other fees, in the aggregate, or which are in excess of such fines, penalties, deposit requirements, or other obligations, prohibitions, or restrictions directly imposed upon similar exchanges or upon the agents or representatives of such exchanges of such other state or country under the statutes of this state, so long as such laws of such other state or country continue in force or are so applied, the same taxes, licenses, and other fees, in the aggregate, or fines, penalties, deposit requirements, or other material obligations, prohibitions, or restrictions of whatever kind shall be imposed by the department upon the exchanges, or upon the agents or representatives of such exchanges, of such other state or country doing business or seeking to do business in this state.

b. Any tax, license, or other obligation imposed by any city, county, or other political subdivision or agency of a state, jurisdiction, or foreign country on the exchange, or on the agents or representatives, shall be deemed to be imposed by such state, jurisdiction, or foreign country within the meaning of sub-subparagraph a.

41. Agents.—Agents as defined in §§ 626.041, 626.051, 626.062, and 626.914 who are broker members or associate broker members of an exchange shall be allowed only to place on an exchange the same kind or kinds of business that the agent is licensed to place pursuant to Florida law. Direct Florida business as defined in § 626.916 or § 626.917 shall be written through a broker member who is a surplus lines agent as defined in § 626.914. The activities of each broker member or associate broker with regard to an exchange shall be subject to all applicable provisions of the insurance laws of this state, and all such activities shall constitute transactions under his license as an insurance agent for purposes of the Florida insurance law.

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42. Export insurance requirements.—No insurance coverage shall be eligible for export unless it meets all of the following conditions:

a. The full amount of insurance required must not be procurable, after a diligent effort has been made to so procure it, from among the insurers which are authorized to transact and which are actually writing that kind and class of insurance in this state; and the amount of insurance exported shall be only the excess over the amount so procurable from authorized insurers.

b. The premium rate at which the coverage is exported shall not be lower than that rate applicable, if any, in actual and current use by a majority of the authorized insurers for the same coverage on a similar risk.

c. The policy or contract under which the insurance is exported shall not be more favorable to the insured as to the coverage or the rate than under similar contracts on file and in actual current use in this state by the majority of authorized insurers actually writing similar coverages on similar risks; except that a coverage may be exported under a unique form of policy designed for use with respect to a particular subject of insurance if a copy of the form is filed with the department by the surplus lines agent desiring to use the same and is subject to the disapproval of the department within 10 days of filing such form, exclusive of Saturdays, Sundays, and legal holidays, if the department finds that use of such special form is not reasonably necessary for the principal purposes of the coverage or that its use would be contrary to the purposes of this law with respect to the reasonable protection of authorized insurers from unwarranted competition by unauthorized insurers.

d. Except as to extended coverage in connection with fire insurance policies and except as to windstorm insurance, the policy or contract under which the insurance is exported shall not provide for deductible amounts, in determining the existence or extent of the insurer's liability, other than those available under similar policies or contracts in actual and current use by one or more authorized insurers. This sub-subparagraph shall not apply with respect to workers' compensation self-insurance qualified as such under chapter 440.

43. Departmental determination of insurance eligible for export.—The department may by rule declare eligible for export generally, notwithstanding the provisions of subparagraph 42., any class or classes of insurance coverage or risk for which it finds, after a hearing (which it

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shall hold annually or more often) of which notice thereof was given to each insurer authorized to transact such class or classes in this state, that there is no reasonable or adequate market among authorized insurers. Any such rule shall continue in effect during the existence of the conditions upon which the rule is predicated, but is subject to earlier termination by the department.

44. Limitation on export coverage.—Subparagraph 42. does not apply to wet marine and transportation or aviation risks which are subject to § 626.917.

45. Wet marine, transportation, and aviation coverage eligible for export.—Insurance coverage of wet marine and transportation or aviation risks as defined in § 624.607(1)(a)1. may be exported under the following conditions:

a. The insurance shall be placed only by or through a surplus lines agent licensed in this state;

b. The underwriting member shall be one made eligible by the department specifically for such coverage, based upon information furnished by the underwriting member and indicating that the underwriting member is well able to meet its financial obligations; and

c. The surplus lines agent shall, within 60 days after procurement of the policy or contract, file with the department a copy of the policy, cover note, or contract. This subparagraph shall not apply as to pleasure boats, nor as to private aircraft owned by private owners for business and pleasure purposes only (excluding commercial purposes), exclusive of check-flight or ferry-flight coverage only.

46. Premium payments and other requirements.—If an underwriting member has assumed the risk as to a surplus lines coverage placed under subparagraph 42., subparagraph 43., or subparagraph 45., and if the premium therefor has been received by the surplus lines agent who placed such insurance, then in all questions thereafter arising under the coverage as between the underwriting member and the insured, the underwriting member shall be deemed to have received the premium due to it for such coverage; and the underwriting member shall be liable to the insured as to losses covered by such insurance, and for unearned premiums which may become payable to the insured upon cancellation of such insurance, whether or not in fact the surplus lines agent is indebted to the underwriting member with respect to such insurance or for any other cause. Any direct business as defined in § 626.916 or

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§ 626.917 placed on the exchange shall also meet the requirements of §§ 626.920, 626.922, and 626.923.

47. Improperly issued contracts, riders, and endorsements.—

a. Any insurance policy, rider, or endorsement issued by an underwriting member and otherwise valid which contains any condition or provision not in compliance with the requirements of this section shall not be thereby rendered invalid, except as provided in § 627.415, but shall be construed and applied in accordance with such conditions and provisions as would have applied had such policy, rider, or endorsement been in full compliance with this section. In the event an underwriting member issues or delivers any policy for an amount which exceeds any limitations otherwise provided in this section, the underwriting member shall be liable to the insured or his beneficiary for the full amount stated in the policy in addition to any other penalties that may be imposed.

b. Any insurance contract delivered or issued for delivery in this state governing a subject or subjects of insurance resident, located, or to be performed in this state which, pursuant to the provisions of this section, the underwriting member may not lawfully insure under such a contract shall be cancellable at any time by the underwriting member, any provision of the contract to the contrary notwithstanding; and the underwriting member shall promptly cancel the contract in accordance with the request of the department therefor. No such illegality or cancellation shall be deemed to relieve the underwriting syndicate of any liability incurred by it under the contract while in force, or to prohibit the underwriting syndicate from retaining the pro rata earned premium thereon. This provision does not relieve the underwriting syndicate from any penalty otherwise incurred by the underwriting syndicate.

48. Satisfaction of judgments.—

a. Every judgment or decree for the recovery of money heretofore or hereafter entered in any court of competent jurisdiction against any underwriting member shall be fully satisfied within 60 days from and after the entry thereof, or, in the case of an appeal from such judgment or decree, within 60 days from and after the affirmance of the judgment or decree by the appellate court.

b. If the judgment or decree is not satisfied as required under subsubparagraph a., and proof of such failure to satisfy is made by filing with the department a certified transcript of the docket of the judgment or the decree together with a certificate by the clerk of the court wherein

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the judgment or decree remains unsatisfied, in whole or in part, after the time provided in sub-subparagraph a., the department shall forthwith prohibit the underwriting member from transacting business. The department shall not permit such underwriting member to write any new business until the judgment or decree is wholly paid and satisfied and proof thereof is filed with the department under the official certificate of the clerk of the court wherein the judgment was recovered, showing that the judgment or decree is satisfied of record, and until the expenses and fees incurred in the case are also paid by the underwriting syndicate.

49. Tender and exchange offers.—No person shall make either a tender offer or an exchange offer for 10 percent or more of the outstanding voting securities of an underwriting member or purchase 10 percent or more of the ownership of an underwriting member unless such person has filed with the department and sent to such underwriting member a statement setting forth:

a. The identity of, and background information on, each person by whom, or on whose behalf, the acquisition is to be made; and if the acquisition is to be made by or on behalf of a corporation, association, or trust, the identity of and background information on each director, officer, trustee, or other natural person performing duties similar to those of a director, officer, or trustee for the corporation, association, or trust.

b. The source and amount of the funds or other consideration used, or to be used, in making the acquisition.

c. Any plans or proposals which such person may have to liquidate such member, to sell its assets, or to merge or consolidate it.

d. The percentage of ownership which such person proposes to acquire and the terms of the offer or exchange, as the case may be.

e. Information as to any contracts, arrangements, or understandings with any party with respect to any securities of such member or controlling company, including, but not limited to, information relating to the transfer of any securities, option arrangements, puts or calls, or the giving or withholding of proxies, naming the party with whom such contract, arrangements, or understandings have been entered and giving the details thereof.

50. Background information.—The information as to the background and identity of each person about whom information is required to be

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furnished pursuant to sub-subparagraph 49.a. shall include, but shall not be limited to:

a. Such person's occupations, positions of employment, and offices held during the past 10 years.

b. The principal business and address of any business, corporation, or other organization in which each such office was held or in which such occupation or position of employment was carried on.

c. Whether, at any time during such 10-year period, such person was convicted of any crime other than a traffic violation.

d. Whether, during such 10-year period, such person has been the subject of any proceeding for the revocation of any license and, if so, the nature of such proceeding and the disposition thereof.

e. Whether, during such 10-year period, such person has been the subject of any proceeding under the Federal Bankruptcy Act or whether, during such 10-year period, any corporation, partnership, firm, trust, or association in which such person was a director, officer, trustee, partner, or other official has been subject to any such proceeding, either during the time in which such person was a director, officer, trustee, partner, or other official, or within 12 months thereafter.

f. Whether, during such 10-year period, such person has been enjoined, either temporarily or permanently, by a court of competent jurisdiction from violating any federal or state law regulating the business of insurance, securities, or banking, or from carrying out any particular practice or practices in the course of the business of insurance, securities, or banking, together with details of any such event.

51. Security fund.—All underwriting members shall be members of the security fund of any exchange.

52. Underwriting member defined.—Whenever the term "underwriting member" is used in this subsection, it shall be construed to mean "underwriting syndicate."

53. Offsets.—Any action, requirement, or constraint imposed by the department shall reduce or offset similar actions, requirements, or constraints of any exchange.

54. Restriction on member ownership.—The investment in any member by brokers, agents, and intermediaries transacting business on the exchange, and the investment in any such broker, agent, or intermediary

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by any member, directly or indirectly, shall in each case be limited in the aggregate to less than 20 percent of the total investment in such member, broker, agent, or intermediary, as the case may be.

55. Premium defined.—"Premium" is the consideration for insurance, by whatever name called. Any "assessment" or any "membership," "policy," "survey," "inspection," "service" [2]fee or charge or similar fee or charge in consideration for an insurance contract is deemed part of the premium.

56. Rules.—The department shall promulgate rules necessary for or as an aid to the effectuation of any provision of this section.

(7) The performance of the contractual obligations of the exchange or its members entered into pursuant to subsection (1) shall not be covered by any of the Florida state security or guaranty funds.

History.—§§ 3, 4, ch. 79-394; §§ 23, 24, ch. 80-236; §§ 1, 2, ch. 80-272

[1] The words "receipt of a" were inserted by the division of statutory revision.

[2] The words "fee or charge" were inserted by the division of statutory revision.

[Page 605 follows]

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COMMITTEE ON
RECEIVED
JUN 2 . 1982
WAYS AND MEANS

MOSS ADAMS
ADMINISTRATIVE OFFICE

June 16, 1982

Honorable John J. Salmon
Chief Counsel
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Sir:

This letter is in response to your request for comments on H.R. 6055 dealing with the revision of Subchapter S of the Internal Revenue Code.

There is one aspect of Subchapter S which has had the practical effect of preventing its use by many companies in the forest products industry. As you are aware, section 631 of the Internal Revenue Code has as its purpose the providing of an incentive for the industry to utilize good forest management practices in re-foresting its lands and providing a steady supply of wood products to the economy. It accomplishes this purpose by allowing companies in the industry to treat a portion of their regular business earnings derived from cutting their timber and manufacturing it into useful end products as capital gains income. I would emphasize that we are not dealing with a windfall profit from some extraneous source, but with the recurring day to day activities of these companies in the normal course of their business. In essence, section 631 is analogous to the incentives provided the mining industry by section 613 (percentage depletion), 616 (development expenses) and 617 (exploration expenses).

Section 1378 (section 1374 as revised by H.R. 6055) provides that if, during the first three years of an election under Subchapter S, a company realizes capital gains income, the company must pay a tax on such gains, and in addition the shareholders must then pay a tax on the net amount. The purpose of this provision is to prevent a perceived abuse of Subchapter S whereby companies which were in receipt of a windfall profit from a source extraneous to their regular business, could elect under Subchapter S, extract the windfall profit with but a single capital gains tax, and then abandon the election.

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Unfortunately, this provision acts to exact a toll charge from companies in the forest products industry by forcing them to pay an added tax on what is their regular recurring business income, if they wish to utilize the election. The practical effect is a denial of the ability to make the election.

That gains from timber should be treated differently from other types of capital gains is an accepted concept in the Internal Revenue Code. Section 57(a)(9)(C) dealing with items of tax preference makes such a distinction. In addition, section 512(b)(5) treats such gains as business income, thus excepting them from the exclusion of capital gains from the definition of unrelated business income.

We would urge the Committee to correct this situation by amending proposed section 1374 in H.R. 6055 to read in part as follows:

> "(A) GENERAL RULE. - If for a taxable year of a S corporation -
>
> > "(1) the net capital gain (other than gains described in section 57(e)) of such corporation exceeds . . . . ."

(underscored material added)

Respectfully submitted,

John Van Horn
For
MOSS ADAMS

STATEMENT OF THE NATIONAL ASSOCIATION OF MANUFACTURERS

The National Association of Manufacturers welcomes the opportunity to submit comments on H.R. 6055, the Subchapter S Revision Act of 1982. The National Association of Manufacturers represents over 12,000 member companies, over 80 percent of which have less than 500 employees.

The National Association of Manufacturers applauds the main thrust of this legislation which is to alleviate unnecessary rules and restrictions in an effort to simplify Subchapter S. However, we have the following reservations:

A. TREATMENT OF DISC

Current law allows a Subchapter S shareholder to own a DISC. Inclusion of a DISC as a member of an affililated group is an unnecessary change which would unfairly discriminate against Subchapter S corporations with regard to DISC ownership.

B. PASSIVE INVESTMENT INCOME LIMITS

Current law revokes Subchapter S status if more than 20% of gross receipts in any taxable year is passive income.

H.R. 6055 makes great progress by eliminating this test for Subchapter S corporations with no accumulated earnings and profits at the close of the taxable year. However, we believe that the passive income test should be completely eliminated. The reasons for this are:

1. It is often difficult for small business to tell the difference between passive and active income. This is particularly true in light of recent changes in the treatment of capital cost allowances.

2. The test serves no revenue purpose. Strict limitations on qualified corporate retirement plans and the reduction in individual passive income tax rates have eliminated the revenue need for this test.

3. Due to the passive income test, an existing corporation is in the position of having to distribute its earnings with the risk that if it distributes too much it will be forced to operate with low capital resources and if it distributes too little, its Subchapter S status will be revoked anyway.

In conclusion, there seems to be no reason to retain burdensome passive income restrictions.

C. FOREIGN INCOME LIMIT

H.R. 6055 fails to address the 80% limit on foreign source income which is applied under current law. We feel this restriction should be removed. Opportunities for tax avoidance are effectively restrained by Subchapter N. There is no reason for this limitation on Subchapter S corporations.

D. TAXABLE YEAR

The proposal that a Subchapter S corporation must use a calendar year would add complexity for many companies, particularly those using LIFO. This requirement is unnecessary.

In conclusion, the National Association of Manufacturers supports H.R. 6055 with the above modifications.

STATEMENT OF JAMES L. POWELL, CHAIRMAN, TAX COMMITTEE, NATIONAL CATTLEMEN'S ASSOCIATION

The National Cattlemen's Association (NCA) submits the following written statement for the record of the hearings on H.R. 6055, the Subchapter S Revision Act of 1982.

NCA commends Mr. Rostenkowski and Mr. Conable for introducing H.R. 6055, which would make extensive revisions in the income tax treatment of subchapter S corporations and their shareholders. NCA also commends the Congressional staffs and the Treasury Department for their attempts to address all of the significant problems in this area of the tax law.

NCA generally supports the provisions of H.R. 6055, which would treat the shareholders of a subchapter S corporation more like the partners of a partnership than does present law. In particular, NCA supports the provisions which would:

(1) pass through items of income, gain, loss deduction, and credit from a subchapter S corporation

to its shareholders in a manner similar to the manner such items pass through a partnership to its partners;

(2) allow a shareholder to carry forward his share of the corporation's loss to the extent that the amount of loss passed through to him for the year exceeds the aggregate amount of the bases in his subchapter S stock and loans to the corporation;

(3) eliminate the passive investment income test for corporations which do not have accumulated earnings and profits; and

(4) revise the rules relating to distributions from subchapter S corporations.

However, NCA suggests that the passive investment income test should also be eliminated for corporations with accumulated earnings and profits if all of such accumulated earnings and profits are attributable to years for which the corporation was a subchapter S corporation.

While NCA supports the concept that the rules relating to pensions and fringe benefits should not depend upon the form in which the business is conducted, the solution provided by the bill is incomplete and inequitable. Treating subchapter S corporations, their shareholders and employees in the same manner as partnerships, their partners and employees may create a parity between partnerships and subchapter S corporations, but it leaves intact the disparity between partnerships and regular corporations and increases the disparity between subchapter S corporations and regular corporations. NCA suggests that fringe benefits and retirement plan rules should not be restricted on a piecemeal basis in this bill; rather, fringe benefits and retirement plans should be examined on a comprehensive basis with a view to applying uniform rules to all taxpayers regardless of the form in which they carry on their businesses.

June 11, 1982

Honorable Dan Rostenkowski, Chairman
House Ways and Means Committee
1102 Longworth
House Office Building
Washington, DC 20515

Dear Congressman Rostenkowski:

We wish to express our enthusiastic support for the Subchapter S Revision Act of 1982. The changes made by the Act are consistent with the original intent of Subchapter S and are particularly meaningful at this time.

The Subchapter S provisions were enacted to allow small businesses freedom in the selection of the form of business organization without the necessity of taking into account major differences in tax consequences. The Subchapter S Revision Act furthers this goal by amending the Subchapter S provisions to make taxation of S corporations more consistent with taxation of partnerships and sole proprietorships.

Fiscal policy should compliment and enhance economic policy. Especially during these troubled economic times, small businesses should be allowed to plan and grow without the encumbrances of complex tax considerations. The Subchapter S Revision Act will allow small businesses to place more emphasis on the economic benefits of a transaction rather than on after-tax consequences. By simplifying the tax structure for small businesses, the Act will provide an incentive for increased business activity, stimulating economic growth.

Because of the current recession it is desirable to provide the stimulus as soon as possible, and it is recommended, therefore, that the effective date of the Act be changed to the date of enactment. This will result in increased business activity by new entities encouraged by the traditional protections of the corporate form without the encumbrances of complex corporate tax regulations and should also result in new activity by existing corporations which then could qualify as S corporations. We think this legislation is most timely because of the critical need to stimulate business activity.

We commend the Senate Finance Committee, the House Ways and Means Committee and their respective staffs for this excellent bill, and we encourage its adoption at the earliest date.

Yours truly,

Marvin R Blumberg

Marvin R. Blumberg
Chairman of the Board

MS/ms

STATEMENT OF THE SECURITIES INDUSTRY ASSOCIATION

Mr. Chairman and members of the committee. The Securities Industry Association appreciates the opportunity to comment on H.R. 6055, the "Subchapter S Revision Act of 1982."

SIA represents nearly 550 leading investment banking and brokerage firms headquartered throughout the United States which collectively account for approximately 90 percent of the securities transactions conducted in this country. The activities of SIA members include retail brokerage conducted on behalf of 32 million individual shareholders, institutional brokerage, over-the-counter market making, various exchange floor functions and underwriting and other investment banking activities conducted on behalf of corporations and governmental units at all levels.

We would like to take this opportunity to commend the House Ways and Means Committee, the Senate Finance Committee, the Treasury Department as well as the many professional organizations for their fine efforts on behalf of reforming and simplifying the tax provisions governing subchapter S corporations. H.R. 6055 goes a long way toward expanding the use of subchapter S corporations and eliminating many of the "traps for the unwary" of present law.

The Securities Industry Association, in general, supports H.R. 6055 and urges its prompt enactment into law. In particular, we strongly endorse the proposals to increase in the number of eligible shareholders from 25 to 35, to relax the one class of stock rule to allow differences in voting rights in common stock and to preserve to the shareholder of the character of corporate items of income, deduction, loss and credit. All these provisions, we believe, will result in the more widespread use of subchapter S corporations.

Passive Income Limitation

Our members, however, have a unique problem which results in their present inability to elect subchapter S corporation status and which would continue to present difficulties even under H.R. 6055. Their problem relates to the passive income limitation of Internal Revenue Code section 1372(e)(5) which disqualifies from subchapter S status a corporation which derives more than 20 percent of its gross receipts from "royalties, rents, dividends, interest, annuities, and sales or exchanges of stock or securities (gross receipts from such sales or exchanges being taken into account for purposes of this paragraph only to the extent of gains therefrom)." Many of our members are stock exchange specialists who primarily deal in selected stocks. They derive a significant portion of their income from trading in these stocks and, therefore, are precluded by the present passive income limitation from qualifying as subchapter S corporations.

Although H.R. 6055 generally will simplify the operative rules of subchapter S corporations and ease the eligibility requirements, it will not alleviate the eligibility problem for securities dealers. Proposed Code section 1362(d)(3)(A)(i), as provided in the bill, states that an election "shall be terminated whenever the corporation. . .has gross receipts for any taxable year more than 20 percent of which is passive investment income and. . .has accumulated earnings and profits at the close of such taxable year." The effect of this provision would be to prohibit a securities dealer from electing subchapter S status unless he distributes all his accumulated earnings and profits. We (do not) believe that this requirement is unjustified in the case of a securities dealer. If he is required to distribute all accumulated earnings and profits, he may not have sufficient capital to operate his business.

Moreover for securities dealers, the income from trading activity is derived not from passive investments, but from the active conduct of a trade or business. This has been recognized by Congress in the provisions of Code Section 1236 which requires dealers to distinguish between securities held as inventory and those held for investment. Therefore we strongly urge that the proposed legislation be modified to redefine passive income to include income from the sale or exchange of only those securities held for investment by dealers. This modification would exclude from the passive income of securities dealers their trading income. Securities dealers would then be treated the same as other active businesses and would be allowed to elect subchapter S status.

We note that both the American Bar Association Section on Taxation and the AICPA Federal Tax Division in their written comments to the Committee also have suggested revision of the definition of passive income to exclude income that is clearly "active" income to certain corporations. Income from trading stock or securities by a securities dealer is clearly not the type of income that the passive income limitation was enacted to control. Thus, exclusion of such dealer income from the passive income limitation which would allow these corporations to elect subchapter S status would not create a tax abuse situation and would be in clear furtherance of the intention of H.R. 6055 which is to expand the use by active businesses of subchapter S corporation status.

Conclusion

The Securities Industry Association generally endorses H.R. 6055, although we strongly urge that the definition of passive income be modified to exclude the active income earned by dealers from the sale or exchange of securities.

ANCHORAGE, ALASKA, *June 18, 1982.*

Re enactment of the subchapter S changes contained in H.R. 6055.

JOHN J. SALMON, Esq.,
Chief Counsel, Committee on Ways and Means,
House of Representatives, Washington, D.C.

DEAR MR. SALMON: The purpose of this letter is to urge support by the House Committee on Ways & Means for H.R. 6055, which contains a proposed simplification of the tax rules relating to Subchapter S corporations. These changes will greatly increase the availability and operation of the Subchapter S corporation for small businesses. Consequently, these businesses will be able to obtain the non-tax legal advantages of a corporate entity, and the Subchapter S corporate tax advantage of only a single level of federal corporate taxation.

Perhaps the single most significant change in the proposal is the elimination of most of the "passive income," restrictions, contained in the Subchapter S taxation scheme. I would like to emphasize a very specific benefit which this change will provide to numerous taxpayers presently caught in a tax "nightmare," due to inadequate tax planning. Let me explain. With proper tax planning, the owner of a small business may sell his business and receive the proceeds in the form of installment payments, which are only taxed once, at capital gain rates, when these payments are received. Prior to 1980, such taxpayers could achieve this desirable tax result by selling their stock, on the installment method. After enactmeant of the Installment Sale Act in 1980, such business owners could also obtain the above-described tax treatment by having the corporation elect an I.R.C. § 337 plan of liquidation, sell its assets on the installment method, and distribute the installment sale notes to the shareholders. Again, only one capital gain tax would be paid by the shareholders, as they received the installment proceeds.

Unfortunately, numerous owners of small businesses have not received the above-described type of adequate tax advice. Instead, they have sold their businesses by having the corporation sell its assets on the installment method. If this occurred before 1980, or in 1980 or later but without proper adoption of an I.R.C. § 337 plan of liquidation, then the tax consequences become disastrous. Instead of a single capital gain tax imposed upon the shareholders when they receive the installment payments over the pay-out period, two taxes are imposed. First the installment payments are taxed to the corporation, at capital gain rates. When the corporation subsequently distributes the proceeds to its shareholders, another taxable event occurs. The I.R.S. may often assert that this second tax should be taxed at ordinary income tax rates, rather than the more favorable capital gain rates, on the ground that the distributions are dividends. The resulting taxes are more than double the taxes that would be paid if the transaction had been correctly planned. The above-described tax nightmare is extremely unfair because it could have been completely avoided by proper tax planning. Once caught in this trap, the existing solutions are ambiguous and uncertain. A Subchapter S election is not available, due to the present passive income restrictions (interest received is more than 20 percent of gross receipts).

However, the proposed changes eliminating the passive income restrictions for Subchapter S corporations should provide a sound and fair solution to this problem. The liquidating corporation could elect Subchapter S status. For three years, the I.R.C. § 1378 tax would apply. Therefore, as each installment payment was received, the corporation would pay that tax. When the remaining funds were subsequently distributed to the shareholders, a capital gain tax would be paid by them, pursuant to the pass-through concept of the Subchapter S corporation. After three years, only one capital gain tax would be paid on each installment payment, pursuant to the latter concept. Therefore the selling owner of the small business would be placed back in the position in which he would have been in, had he received proper tax advice before he sold his business.

For the reasons stated above, I urge the House Committee on Ways & Means to support H.R. 6055, and to pursue its rapid enactment. The benefits to the small businessman and to the taxpayers presently suffering from the above-described tax "nightmare," deserve the Committee's immediate consideration.

Very truly yours,

DAVID G. SHAFTEL.

Winter, Kloman, Moter & Repp, S.C.
June 3, 1982.

Re comments on pending subchapter S legislation.

John J. Salmon,
Chief Counsel, Committee on Ways and Means,
House of Representatives, Washington, D.C.

Gentlemen: On behalf of my colleagues and myself, I wish to comment on the pending legislation regarding changes to the existing Subchapter S provisions of the Internal Revenue Code.

1. We support the termination of restrictions on the percentage of passive income limited to existing Subchapter S corporations. There should be no restrictions on passive income.

2. We further support the discontinuance of the limitations upon the use of only one class of stock and the nature of that stock.

3. We do disagree upon paralleling the treatment of corporation fringe benefits and pension benefits to those of a partnership. There is a distinct separation of entity and there is a definite employee-employer relationship, and as such, all employees should be eligible to obtain identical fringe benefits, be it owner or employee.

4. We strongly suggest that your committee recommend legislation which will permit a Subchapter S corporation to terminate such status within the first 75 days prior to or after the end of the calendar or fiscal year. This termination period is currently only 30 days, and is not a long enough period to permit most small businessmen, with relatively unsophisticated accounting records, an adequate time to determine whether the status should in fact be terminated within the 30-day period. By permitting the businessman the 75-day period to determine whether termination is practical would provide him a period comparable to the time he is permitted to assemble his data and file his corporate income tax return for the year. Further consideration should be given to extending the 75-day period based upon the extension granted for that taxpayer's income tax return. Unfortunately we have seen several small businessmen who were too quick to terminate the Subchapter S corporation status, and in so doing have sustained economic and tax losses which could have been much more beneficial to them and the survival of their business if they had taken these losses personally.

5. Consideration should also be given to permit the use of loans as basis of the shareholders in which they have personally guaranteed the repayment of those loans even though the corporation is the named debtor. In real life small business, virtually all bank loans have to be personally guaranteed by the stockholder, and as such, are in fact really his indebtedness.

We thank you, gentlemen, for allowing us to express our comments, and if we can clarify them in any way, please feel free to contact me.

Very truly yours,

James S. Repp, CPA.

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